Guide to Sound Practices for European Hedge Fund Managers

30 August 2002

Table of Contents

Foreword

The European hedge fund market has been growing rapidly over recent years, with sources indicating an increase of over 300% in assets managed in Europe from 1999 to 2002. The need for Hedge Fund managers and their service providers to provide sound professional services as well as increased transparency has never been greater. Leading European industry participants acknowledge this need and, together, have compiled this "Guide to Sound Practices for European Hedge Fund Managers".

The Guide provides an overview of the many issues that should be considered by a Hedge Fund manager, but is not intended to set out definitive standards or an exhaustive list of requirements that could serve as a benchmark against which conduct should be assessed. There is no substitute for professional advice in managing a hedge fund business.

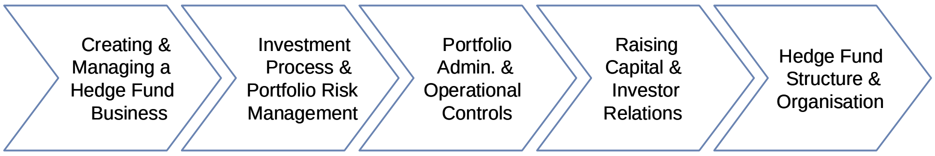
Like any growing industry, we all owe much to those who have the foresight and dedication to create valuable tools for the assistance of all participants. A number of companies and individuals have extended considerable time and effort in creating the Guide and we acknowledge their invaluable input on page 32. A core group of investment managers, prime brokers, Hedge Fund administrators, consultants, lawyers, accountants and an investor met regularly over a nine-month period and produced a draft of the Guide. The draft was then made publicly available through several industry web sites over a four week consultation period during which comments were received from a broad range of industry participants. It is intended that the Guide will be reviewed on a regular basis so its value to the industry does not depreciate. To this end, comments should be sent to:

EuropeanSoundPractices@ln.email.gs.com.

This project was originally suggested by Hedge Fund managers participating in a Goldman Sachs client conference, and we wish to note our gratitude to **Goldman Sachs**, which committed its leadership and substantial resources to the success of this project across the industry. Particular thanks are extended to Segun Aganga of Goldman Sachs Prime Brokerage, who led the effort, and undertook the considerable coordination of this project.

Hans-Willem van Tuyll
Chairman, The Alternative Investment Management Association Limited (AIMA)

30 August 2002



Introduction

This Guide considers various practical aspects of establishing and managing a Hedge Fund business in Europe and suggests corresponding sound practices. It is intended to be a useful tool to a wide variety of Hedge Fund managers, notwithstanding differences in terms of investment strategies employed or personnel, capital resources or systems capabilities.

Specifically, the Guide covers the following key topics:

i. creating and managing a Hedge Fund business;

ii. the investment process and portfolio risk management;

iii. portfolio administration and operational controls;

iv. raising capital and investor relations; and

v. Hedge Fund structures and organisation.

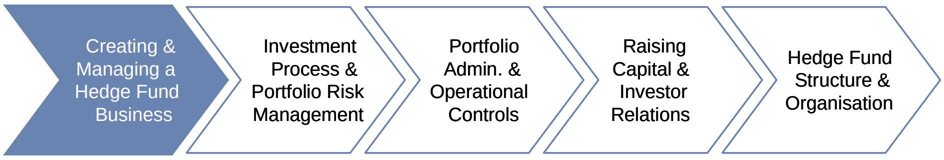
Whilst the intention has been to produce a resource for general use, it should not be assumed that one size fits all. The size, nature, jurisdiction of regulation and complexity of a particular Hedge Fund manager's operations and investment strategy may mean that some or all of the sound practices set out in the Guide are in fact inappropriate to the business of a particular Hedge Fund manager. Accordingly, the sound practices should not be regarded as definitive or "best" practices.

As a general resource, the Guide should not be regarded as a substitute for professional advice, which should still be obtained where appropriate. The Guide does not replace any applicable laws or regulations, which are likely to be more detailed than the sound practices described. To the extent that the Guide refers to legal or regulatory issues, this is based on the UK regime. However many of the principles can be applied in the wider European environment.

The content and format of each chapter is designed to maximise the Guide's use as a practical and user-friendly tool, rather than a textbook. The Guide can be obtained from the following web sites:

www.aima.org
www.eurohedge.com
www.albournevillage.com
www.hedgefundsreview.com

30 August 2002



1. Creating and Managing a Hedge Fund Business

Establishing a Hedge Fund management business involves creating and managing a viable business.

The principals of the Hedge Fund management business, as the proprietors and/or controllers of a financial services business, are responsible for all aspects of that business and should give due consideration to the business risks involved at the start and throughout the life of the business.

This Chapter reviews the requisite management systems and controls internal to a Hedge Fund management business. It does not extend to portfolio management, nor the interfaces with Hedge Funds or managed portfolios, each of which are addressed separately in subsequent chapters. Although Hedge Fund management businesses are typically small, they may manage very large amounts of assets, with the result that the consequences of actions or omissions by the manager may have a significant impact on investors and the wider investment community. For this reason, an attempt is made to emphasise below the importance of strong procedures and controls, segregation of duties (where possible), managing the business risks involved and the need for skilled and experienced personnel whether or not on an employed or externally retained basis.

The issues discussed below are common to all financial services businesses; however the following guidance is intended to reflect the application of sound practice in the areas discussed to a typical Hedge Fund management business.

1.1 Creating a Hedge Fund Management Business

Creating a Hedge Fund management business is no different from establishing any other business. However most Hedge Fund management businesses are small, at least at the outset, and unlike other small businesses, are supported by a number of service providers such as prime brokers, administrators, compliance consultants, systems providers, Hedge Fund consultants, accountants and lawyers. This allows a small number of personnel to easily access a wide skill base.

There are a number of considerations which the principals of the Hedge Fund management business need to address when setting up their business. These include:

i. the business opportunity;

ii. short, medium and long term goals;

iii. the legal and tax structure;

iv. ownership and funding of the management entity;

v. regulatory environment and requirements;

vi. investment strategy and key features;

vii. size and type of the target investor market and marketing strategy;

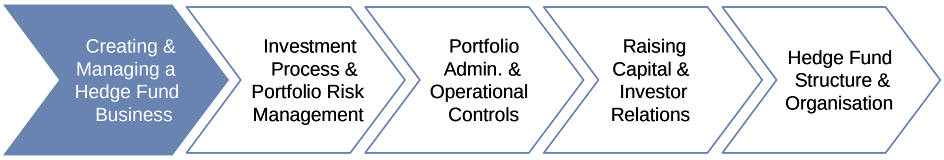
viii. management team and staffing requirements;

ix. service providers and professional advisers;

x. systems and IT requirements;

xi. risk assessment and sensitivity analysis; and

xii. financial forecasts and critical milestones.



It is important to seek advice from competent and experienced professional advisers or consultants in some of these areas to reduce or eliminate the business risks involved in setting up a new business. For example the structure and manner of operation of the management business should not only be tax efficient and flexible but should be cost effective and easy to implement.

Some principals find it useful to address these matters in a business plan. The business plan can then be used to ensure that investments in people, technology and infrastructure are appropriately aligned with each other and with the overall objectives of the business. Furthermore, each of these investment decisions should be made in light of the anticipated future development of the business, in order to ensure that the business retains the flexibility to develop within the parameters of its proposed plans. The business plan may also cover a number of longer term issues relevant to the manner in which the business is established and run. These may include a strategy to grow the business, planned exit route for the founders or the introduction of other principals and shareholders. Equally any plan should recognise any upper limit to the capital which can be invested effectively in any particular investment strategy.

1.2 Managing a Business

In many cases the principals of a Hedge Fund management business are also controllers of a financial services business, with related responsibilities which are significantly wider than the areas of portfolio management that they may have historically focused upon. Some of those areas – management and controls, finance, compliance and employee issues - are discussed further below. Other areas such as risk management, product development, operations and marketing are addressed in the other chapters.

1.3 Management and Controls

Every Hedge Fund management business, whatever its size, should organise its internal affairs in a responsible manner, ensuring it has appropriate systems, procedures and controls designed to mitigate and manage the risks to which the business is subjected. This should be documented but the extent of documentation will vary depending on the complexity of the business operations.

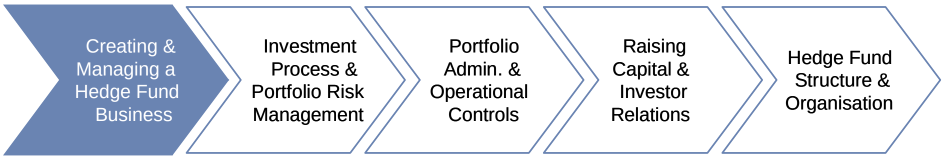
Management should implement a business risk management process to assess all the non-investment risks associated with the business, although the degree of formality of this process will vary widely dependent upon the size and complexity of the business. It may, for example, range from an informal process conducted at management meetings to, in the case of a larger firm, a formal and rigorous process. The risk management process would typically encompass:

i. the identification of the key risks facing the business, across all areas, including risks such as reliance on key clients or investors, reliance on key staff and access to sufficient capital.

   A formal risk assessment of the business should be carried out no less frequently than on an annual basis and approved by the directors or other governing body. This process should be documented (whether formally or informally).

ii. the implementation of controls to mitigate those risks. For each risk, management should determine whether to accept the risk, avoid the risk, transfer it (e.g. through insurance) or to seek to mitigate the risk through controls. Where this last choice is made, so far as possible, those controls should be embedded in normal business processes. A significant risk to be accepted will be reliance on a few investors and a small number of key staff.

iii. the design of a monitoring process to ensure effectiveness of those controls.



Management should ensure that any internal or monitoring exercise includes a review of the key risks.

iv. reporting on both the effectiveness of controls and the changing risk profile of the business.

Effective controls should ensure that any significant weaknesses are reported to senior management as soon as they are detected and remedied.

The key areas which such risk management systems would typically cover include, inter alia, the broad headings of investment (see Chapter 2), finance, compliance, systems, tax and personnel.

1.3.1 Outsourcing

Where key functions are outsourced, management must be satisfied as to the competency of the relevant service provider and should have a process in place to monitor and review work performed. Such a process may include initial consideration of a number of outsourced service providers against a set of agreed criteria prior to selection and on an ongoing basis:

i. assessment of performance against contractual or agreed standards;

ii. periodic performance review meetings; and

iii. comparison of actual results against expected results.

1.3.2 Allocation of Tasks

It is good business practice to attempt to segregate, amongst different personnel, duties which may be regarded as incompatible with each other. Examples include initiating and approving investment and cash transactions and monitoring portfolio risk. However, this is often difficult to achieve in Hedge Fund management businesses with a limited number of employees. There is a minimal level of steps which can be taken to help reduce the risks. These include ensuring that key transactions, particularly those related to cash, are approved by two personnel and using the control systems and procedures of service providers to verify and oversee transactions.

1.4 Finance

1.4.1 Systems and Accounting Records

Firms should ensure that they have appropriate systems and procedures capable of:

i. developing relevant budgets;

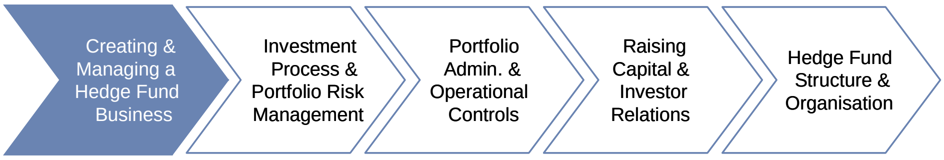
ii. monitoring their financial resources position;

iii. producing timely and accurate management accounting and financial information; and

iv. providing necessary regulatory and statutory financial reports in the format that the jurisdiction requires.

In the case of (i), budgets should be prepared annually and updated where significant changes occur in underlying assumptions. They should include monthly income, expenditure and financial resources forecasts.

Procedures in respect of the processes adopted for each of (i) to (iv) above should be documented and retained.



1.4.2 Financial Resources

Management should have the appropriate knowledge and skills to monitor the financial resources position of the business and to complete relevant regulatory financial filings. Financial regulations in the UK and certain European jurisdictions often dictate the manner of computing financial resources for these purposes. Where possible, a Hedge Fund manager should be capitalised so as to meet the minimum requirements and some contingency to take account of expected future developments.

1.5 Compliance

Typically a Hedge Fund manager will need to have its business authorised or licensed by a local regulatory body. This can be a time-consuming and complex process; obtaining and retaining the correct authorisations for the business the Hedge Fund manager intends to operate is essential. Unless the Hedge Fund manager has the required in-house experience, professional advice should be sought to guide the manager through the initial registration process.

The Hedge Fund manager should also ensure that if any new business activity is planned, the compliance and internal resource requirements are understood and are in place prior to commencing such business.

A Hedge Fund manager should ensure it takes reasonable steps to understand the regulatory environment within which it operates and the specific rules applicable to its business. The Hedge Fund manager should develop procedures to comply with these rules. The manager should additionally ensure that all staff are fully aware of the rules applicable to their particular area of work.

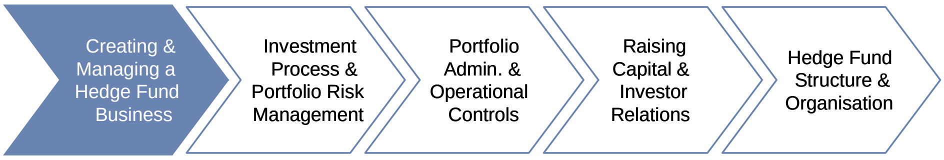
1.5.1 Compliance Function

The Hedge Fund manager should appoint a senior individual to take responsibility for compliance oversight. The manager should ensure that this individual has sufficient time to dedicate to the task and that recurring tasks, such as record keeping and compliance monitoring, are completed on a timely basis. He or she should be vested with the necessary authority to enforce compliance with relevant rules and internal procedures.

It is unusual in smaller managers for the compliance officer to be full time or have a total knowledge of all rules and regulations and where this is the case, the manager should consider having an arrangement with appropriate professional advisers for further advice and guidance. The compliance officer and chief executive must be involved in key compliance issues and should ensure that they provide an appropriate compliance culture in the business.

1.5.2 Compliance Monitoring

The Hedge Fund manager should implement arrangements for the regular monitoring of business risks and for adherence to all compliance requirements. The frequency and scope of monitoring should be determined by the size and complexity of the business. Typically, a Hedge Fund manager would conduct a formal monitoring exercise on at least an annual basis which may be split into monthly or quarterly elements. The results of monitoring should be documented and communicated to management. Procedures should be in place to ensure that where weaknesses have been identified, these are promptly resolved.



1.5.3 Relationship with Regulator

Where the investment business is regulated, managers should seek to retain an open and co-operative dialogue with their regulator.

1.6 Employees

1.6.1 Introduction

Typically Hedge Fund managers employ small teams of specialised professionals who are highly committed and who are known to each other. Nonetheless, management should be committed to ensuring that employees:

i. have the requisite level of knowledge and experience for the tasks they are undertaking;

ii. are and remain competent for the work they undertake, and

iii. are appropriately supervised and that their competence is regularly reviewed.

Senior management should be aware of the dependence which can be placed upon key individuals in a small team and seek to mitigate the risks involved if one of these key individuals leaves the Hedge Fund manager. Managers should give consideration to purchasing professional indemnity and directors and officers liability insurance.

1.6.2 Recruitment

In order to ensure the suitability of new employees, the manager should have in place appropriate recruitment procedures. Typically, such procedures would include an analysis of the specific role (job description), interviewing against that job description and undertaking appropriate due diligence checks on new employees. Such due diligence checks are likely to include seeking formal references. Written terms of employment should, if possible, be in place by the time an employee takes up appointment. Employment may also need to be conditional upon regulatory approvals. The fundamental determinant in selecting an individual for any particular role should be the competence of the individual to carry out that role.

1.6.3 Training

All employees should undergo both induction training and continuous professional development (much of which may be informal in nature). Such training should be designed to introduce the employee to the key business systems, procedures and compliance requirements and to ensure that employees remain up to date with the market, product developments and with changes in rules, laws and regulations. Managers should remain alert to the need for continued training and development of employees, particularly in rapidly changing investment environments or in cases where employees are changing or undertaking new roles.

2. Investment Process and Portfolio Risk Management

This Chapter describes sound practices relating to the creation of an investment process, investment dealing and portfolio risk management. Some of these practices may be very intuitive for individual managers and small teams, but it is important to recognise that investment processes evolve over time and that as a Hedge Fund manager grows and staff change, clear communication about the investment process to both staff involved in its' implementation and investors will help to avoid misunderstandings and reduce the risk of errors.

The implementation of these processes will also depend on the size, complexity and strategy of the portfolio and should be tailored to individual Hedge Fund managers and the style of investment undertaken.

2.1 Investment Process

2.1.1 Investment Strategy

The investment strategy to be applied by the Hedge Fund manager must be clearly articulated to investors and understood by those executing it. With regard to investors, this requires adequate disclosure and explanation of how funds are to be invested, what factors will influence investment performance and what risks are associated with a particular investment strategy. The Hedge Fund manager must be cognisant of these matters and communicate them effectively internally. The Hedge Fund manager should:

i. set out the investment objectives of the strategy;

ii. identify any constraints the strategy imposes, e.g. types of products traded, size, amount of leverage, geographical and market limitations, position and risk limits;

iii. identify the main risks and evaluate how such risks should be managed (i.e. avoidance, hedging or the decision to accept that risk;

iv. comply with any applicable legal or regulatory constraints, including those documented in the relevant Hedge Fund prospectus, and identify how such constraints affect the execution of the investment strategy;

v. have due regard to the prospectus issued in connection with the relevant Hedge Fund and meet the legal and/or regulatory requirements imposed by the Hedge Fund itself;

vi. communicate material changes to the investment strategy on a timely basis; and

vii. ensure the investment strategy is documented and kept up to date.

2.1.2 Managing the Investment Process

A Hedge Fund manager should have a defined investment decision-making process. There are a number of reasons for this:

i. it provides an important control function with respect to the management of the investments;

ii. it provides investors with an understanding of how the investments are managed; and

iii. applicable regulations may require a Hedge Fund manager to adequately control the investment process.

Hedge Fund managers are often small organisations engaged in dynamic and opportunistic markets. Accordingly, the Hedge Fund manager's investment process should impose an investment management discipline, but should also be flexible enough to reflect the resources of the Hedge Fund manager and the market in which it is operating.

Any explanation of the investment process to investors or potential investors should accurately represent what happens in practice and be broadly adhered to thereafter.

A Hedge Fund manager's investment process should:

i. define, at a high level, the steps to be undertaken before an investment decision is taken;

ii. identify any investment restrictions such as position size, concentration limits, short/long balance, amount of leverage, geographical, market and risk limits;

iii. identify who has actual authority to make investment decisions and any limits on such authority;

iv. identify who has responsibility for overseeing the investment decision process and monitoring investment decisions against any internally or externally defined limits;

v. identify who has authority to place orders in the market; and

vi. document the above.

The process should be reviewed and updated regularly. Employees of the Hedge Fund manager should also understand the investment process and their role in it.

2.1.3 Risk Parameters

Hedge Fund managers should assess and evaluate their appetite for risk in connection with a particular investment strategy and ensure that they make investment decisions within such parameters. Setting risk parameters both helps those implementing the strategy to be aware of the nature of the risks of the investment strategy and helps investors to understand how Hedge Fund managers are seeking to manage these risks. Individual Hedge Fund managers may have many different views on the risks involved in their investment strategies and how they attempt to measure these risks. Risk parameters may also help to formalise the investment process and investment strategy.

The Hedge Fund manager should routinely re-evaluate and re-assess its risk parameters.

2.1.4 Position Monitoring and Review

Hedge Fund managers should have a regular process for monitoring investment positions. This can be achieved through position and risk reporting generated internally or provided by a Hedge Fund's prime broker or administrator.

In addition to monitoring the daily profit and loss, the Hedge Fund manager should also take account of other relevant information when assessing individual positions and the overall portfolio, including:

i. position sizes against any applicable limits or caps, whether self-imposed, disclosed to investors or imposed by applicable law or regulation;

ii. ensuring availability of stock to support short sales made;

iii. reconciling trades;

iv. ensuring positions are being marked-to-market on a reliable and consistent basis;

v. ensuring FX exposure is properly understood and addressed;

vi. ensuring hedge positions have been appropriately adjusted for position and price changes or currency exposures;

vii. monitoring pending corporate action and voting deadlines and that instructions are given and position adjusted on a timely basis;

viii. monitoring the maturity of swaps, derivatives and other term trades;

ix. reconciling all credits and debits to the relevant account(s);

x. monitoring investment income and distributions; and

xi. assessing the timing and frequency of such reviews – which will vary depending on strategy and complexity of the portfolio and positions.

Further details on these procedures are discussed in Chapter 3.

2.2 Investment Dealing

Investment dealing is an important part of portfolio management and the Hedge Fund manager should develop a set of procedures to manage its interaction with the market and oversee the conduct of its staff that deal with other counterparties in the market.

Many countries will have their own detailed regulations concerning investment dealing, including such requirements as the need for regulatory approval of individuals, record keeping and reporting of transactions. Hedge Fund managers should ensure that they understand the regulations that apply to them and the markets in which they operate and should have adequate procedures to ensure that they remain in compliance with them.

2.2.1 Dealing Procedure

Hedge Fund managers should have a defined dealing procedure, which illustrates how investment deals are placed in the market and what internal authorisation or controls are required or imposed before the Hedge Fund manager executes a deal. At a minimum Hedge Fund managers' dealing processes should be documented and should:

i. set out, at a high level, the steps to be undertaken before a deal is placed in the market and the responsibility for monitoring the execution of that deal and its reporting;

ii. identify any limits to investment dealing, such as size, nature, geographical, risk limits, counterparty limits, etc;

iii. be clear as to who has the authority and regulatory approval to place investment deals and any limits to such authority;

iv. be clear as to who has responsibility for overseeing the investment dealing process and monitoring the quality of execution both in relation to third party brokers and the Hedge Fund manager's own staff;

v. where appropriate, maintain a segregation of roles between investment decision-making, dealing and trade confirmation and booking;

vi. have a process to deal with trading errors and the impact on net asset value; and

vii. ensure trading records are appropriately documented.

New employees joining Hedge Fund managers should be suitably trained and made aware of the investment dealing process before being allowed to place deals in the market.

2.2.2 Best Execution

The principles of best execution may be defined differently under a number of regulatory regimes and Hedge Fund managers should ensure they understand the implications of, and comply with, the regulations applicable to them. Achieving best execution may not always be appropriate trade by trade, having regard to a particular investment strategy.

A Hedge Fund manager may wish to formally contract out of providing best execution even if it tries to achieve best execution in practice.

2.2.3 Trade Allocation

Hedge Fund managers often operate a number of different investment vehicles, share classes, trading strategies and managed accounts. The fair allocation of trades amongst portfolios should be an overriding principle of business. It is an important control against a number of potential abuses such as front running and favouritism. Procedures to demonstrate that the principles of fair and prompt allocation are enforced should include:

i. the adoption of an allocation policy which should be consistently applied, unless unusual circumstances arise (e.g. if it would be uneconomical to allocate a very small investment to a particular account);

ii. recording the intended basis of allocation of all proposed transactions prior to the transaction taking place (i.e. prior to execution);

iii. prompt allocation of all transactions after execution, usually on the trade date;

iv. ensuring that no allocation is made to the account of the manager or a staff member unless it can clearly be demonstrated that this is in accordance with the intended basis of allocation and that all clients have received their full allocation; and

v. documenting the reason for any reallocation from one account to another. Typically this would only be permitted where the original allocation can be shown to have been made in error.

2.2.4 Use of Derivatives

The different types of derivatives, the various conditions that affect their value, and the continually evolving derivative market can present considerable challenges and risks to derivative users. Whilst many exchange-traded products are widely used and understood, there are many other derivatives that are individually defined, significantly more complex and potentially much higher risk if not used or understood properly.

Failing to identify, understand, and manage the risks associated with derivatives can result in sudden and significant negative impacts. If Hedge Fund managers intend to use derivatives they should:

i. inform investors of their plan to use derivatives, typically in a prospectus or marketing material;

ii. possess the necessary expertise and experience to properly understand how a derivative works and what factors will change the risk profile or pricing of the derivative;

iii. ensure they have software or systems to support the derivatives traded;

iv. ensure there are rigorous controls over entering into, collateralising, recording and managing the expiry of derivatives;

v. ensure they understand the legal documentation defining the nature of the derivatives and the terms of their clearance and or settlement before signing the documents. If managers do not have access to adequate in-house resources reference could be made to expert legal advisers;

vi. clearly understand the different implications of buying versus writing derivatives on positions in their portfolio and on the overall investment strategy; and

vii. ensure derivative positions are independently and consistently fairly priced bearing in mind the market liquidity of such positions. For OTC contracts, trade counter parties are the most frequently used source of independent pricing. In addition to this pricing, Hedge Fund managers should periodically seek to independently check prices either through the use of models or appropriate counterparties.

viii. the Hedge Fund manager should also discuss and agree the accounting and valuation methodology employed with the client or administrator as appropriate and ensure that independent access is provided to the client or administrator directly from the pricing source

2.2.5 Code of Market Conduct

Managers should conduct themselves in a manner in which a reasonable market participant would deem prudent, honest and reputable.

Different jurisdictions will have different laws and regulations relevant to the market conduct of Hedge Fund managers. Hedge Fund managers should ensure that they understand the implications of such regulation. Many of these laws and regulations may be complex and their application may be obscure. Managers should seek advice from the relevant professionals where they are uncertain about their application.

2.2.6 Inducements and Soft Commissions

Inducements and soft commission can be offered to Hedge Fund managers from a variety of sources. Care should be taken to ensure that inducements do not create unacceptable conflicts of interest or influence the Hedge Fund manager against acting in the best interest of its clients.

The practice of using soft commissions (or soft dollars) to pay for certain investment services is permitted by some regulators subject to a number of rules. Hedge Fund managers seeking to pay for investment-related services in this way should ensure that the service itself is a documented legitimate softing service of which clients have been made aware.

Any other forms of inducement, given to or received by Hedge Fund managers or their employees, should be monitored to ensure they are appropriate in the circumstances and not likely to unduly influence the judgment of the recipient.

2.2.7 Conflicts of Interest

The Hedge Fund manager should be aware that potential conflicts of interest might exist or develop. Where they do exist or develop, the Hedge Fund manager should ensure they are reviewed by the senior management of the Hedge Fund manager and by those people responsible for the compliance function.

Once reviewed, the Hedge Fund manager should ensure such conflicts have been either appropriately dealt with or eliminated and disclosed to the relevant parties if this is considered to be necessary.

2.2.8 Personal Account Dealing

The Hedge Fund manager should adopt a personal account dealing policy that ensures that conflicts of interest between staff and clients are effectively managed. The easiest way to avoid conflicts of interest is for a Hedge Fund manager to prohibit personnel from trading on their own account in securities which they analyse or in which they invest for clients. Indeed there are perceived benefits for all if staff are encouraged to invest instead in the client Hedge Funds themselves thereby aligning their interests with those of their investors. However this may not be appropriate in all circumstances. Providing adequate controls exist, personal account dealing may be permitted.

For all personal account dealing the Hedge Fund manager should have:

i. written policies and procedures communicated to and accepted in writing by all employees;

ii. clearance and hard copy confirmation records of relevant transactions; and

iii. monitoring and analysis of all personal dealings by a person competent to ensure proper management of the potential conflicts involved.

2.3 Portfolio Risk Management

Risk management is an important part of portfolio management and should be used to help reduce the likelihood of capital loss and failure. In many cases, Hedge Fund managers will not have a full time risk manager but they should ensure that they have a process in place for managing the level of risk in the portfolio.

2.3.1 Defined Process

There should be a defined risk management process in place, which is both realistic and is regularly used by the Hedge Fund manager, to manage and monitor risk.

i. Hedge Fund managers should identify and understand the sources of risks inherent in their investment styles or processes. As far as is possible these risks should be translated into relevant, measurable risk factors. Typically, a risk measure should estimate the impact of an event on the portfolio and the probability of this event occurring. Managers may consider including risk factors such as market risk, credit risk, liquidity risk, concentration, and counterparty risk. When considering risk, Hedge Fund managers should take into account the interaction between different types of risk;

ii. Hedge Fund managers should define their attitude towards risk by documenting investment restrictions. Where appropriate, quantitative risk measure limits should also be provided; and

iii. Hedge Fund managers should monitor risk on a regular basis. The investment decision makers should be informed on a timely basis about the current level of risk in the portfolio.

A risk management process should deal with both normal and exceptional conditions.

2.3.2 Frequency of Review

i. Hedge Fund managers should adapt the frequency of their risk monitoring to the needs of the portfolio. Monitoring would typically be continuous and should formally occur at appropriate regular intervals;

ii. Hedge Fund managers should reconsider the overall risk management process from time to time to make sure that it remains suitable for the investment strategy. If risk systems such as risk models are in use, they should be flexible enough to allow modifications. A review of the process should typically be performed at least once a year and more frequently during exceptional conditions;

iii. stress testing is one way to simulate exceptional market conditions;

iv. Hedge Fund managers should elaborate scenarios to test the resilience of the portfolio. These scenarios should combine changes in the parameters relevant to the portfolio. Scenarios should include parameters such as current prices, term or forward prices, liquidity, volatilities, correlations and non-linearity;

v. as one source of stress can impact another one, stress testing should cover the interrelationship between risks. Operational risk should be considered as one potential form of stress, although in practice it is difficult to stress test; and

vi. a full portfolio stress test should be conducted as frequently as the Hedge Fund manager believes is required. A formal comprehensive stress test should normally be completed at least once a year.

2.3.3 Independence of Review

Hedge Fund managers should ensure the integrity of the risk monitoring function. Where practical the manager should aim to segregate the risk monitoring function from the investment management function with different people responsible for each.

Where practical, independent personnel should periodically review the application and robustness of the risk management process, including the use of any risk models where used, and ensure that controls and limits are being adhered to.

2.3.4 Market Risk

Market risk includes all kinds of asset and liability price risk: price changes, volatility, non-linearity and correlation, foreign exchange and credit risk. Hedge Fund managers should:

i. seek to identify each major category of market risk and regularly attempt to measure and manage these risks both individually and together;

ii. be aware that there are many methodologies for measuring market risks and that these methodologies may result in wide differences in risk measurement; and

iii. seek to manage the risk exposures of the portfolio within pre-defined internal and or external guidelines. Excesses should be identified and corrected as soon as possible either through hedging or position reduction.

2.3.5 Leverage

Many Hedge Fund managers use leverage which can change the impact of the investment risks in the portfolio. Hedge Fund managers should be conscious of the impact of leverage on the overall risk of a portfolio.

Hedge Fund managers should define the way they measure leverage, which should be monitored regularly. In many cases, daily monitoring will be appropriate.

Managers should consider adjusting the leverage in order to change the overall risk level in the light of the portfolio's strategy and market conditions.

The maximum amount of leverage which can be employed may be constrained by such things as contractual terms and the suppliers of finance. Managers should ensure leverage remains within any such constraints. The maximum level of intended leverage should be disclosed to investors.

2.3.6 Liquidity

Both the liquidity of individual positions and the overall portfolio should be actively managed to ensure a portfolio can meet its liquidity requirements, including allowing investors to withdraw in accordance with the agreed contractual terms.

Market liquidity (i.e. capacity to trade assets) is usually an important risk factor. Therefore, it should be measured and monitored;

Funding liquidity (i.e. available sources of finance to fund positions and redemptions) is a critical risk, highly correlated with other risks. The portfolio's cash requirements should be monitored against available sources of finance. Usually, prime brokers are the major providers of financing.

Liquidity should be managed by having proper procedures, especially fair and documented withdrawal policies, both in normal conditions and in periods of stress.

2.3.7 Counterparty Exposures

Often the vast majority of trades entered into by Hedge Fund managers will be delivery versus payment transactions, which involve less counterparty exposures. There are however other types of trades and periods of sudden stress where counterparty exposures can become significant. Creditworthiness or solvency of a counterparty can become a risk particularly when there are significant unexpected changes. Because this risk is usually not hedged, managers should be aware that this may become a source of risk.

The Hedge Fund manager should have defined procedures for establishing relationships with new counterparties, undertaking a high level review of the quality of the counterparty, credit reviews and for maintaining the necessary documentation. A prime broker should be considered as a significant counterparty.

3. Portfolio Administration and Operational Controls

This chapter identifies sound practices for trading, movements of cash, pricing of portfolios, managing service providers and maintaining appropriate information systems. Ultimately many of these processes will be more or less involved depending on the size, complexity and strategy of the portfolio. Hedge Fund managers often operate separate managed accounts as well as Hedge Funds and the processes and controls for both should be similar.

Almost all Hedge Funds have an independent administrator. Separately managed portfolio accounts should also have some means of independent verification of net asset value calculations. For many portfolios a prime broker is also an important service provider to provide effective clearance and settlement as well as position and portfolio reporting. Day to day, the Hedge Fund manager is responsible for liaising with and monitoring information flow between itself, the administrator and the prime broker.

Before the launch of any Hedge Fund and the appointment of any service providers, it is important that the particular needs of the relevant investment strategy are identified. The Hedge Fund manager should be satisfied that the service provider has the requisite level of expertise and technology to deliver the services required to effectively support the investment strategy and investor base.

Once the administrator and prime broker (if appropriate) are identified, there should be careful negotiation of their contracts to ensure that they reflect the particular requirements of the Hedge Fund. The Hedge Fund manager should understand the key provisions of such contracts. Appropriate due diligence should be undertaken to confirm that the requisite services can be delivered and service standards should also be agreed.

3.1 Trade Procedures

Hedge Fund managers should record detailed information on all trades executed on its own systems as well as ensuring they are sent to the Fund's prime broker or settlement agent and administrator promptly. In some cases, the manager may want to outsource some or all of these processes. If this is the case, it is important to verify that the outsourcing counterparty has appropriate procedures in place.

i. Once a trade has been executed, the manager needs to record all the details of the trade which can be done by updating the trade details on a trade blotter, entering the trade into a position keeping system or writing a trade ticket.

ii. Details which need to be recorded include:

  a) the security traded
  b) the counterparty the trade was executed with
  c) the time of the trade
  d) the type of trade, i.e. buy, sell, short, cover
  e) the form of the transaction such as ordinary, CFD, swap, forward etc.
  f) the quantity of units traded
  g) the price
  h) the trade and settlement date
  i) the commission rates and any other charges such as stamp duties.

iii. If the trade is to be allocated over different accounts, the method to be used needs to be recorded.

iv. All trades should be confirmed with the counterparty. It is a sound practice to confirm the trade details with the counterparty on trade date as this reduces any likelihood of problems, such as failed settlement or incorrect risk measurement of the portfolio.v.Details of the trade should be passed to the relevant prime broker and to the administrator. In most cases this will be done electronically thereby reducing the risk of error in re-keying any information.

vi. The Hedge Fund manager should create a log of trades sent so that all trades and trade details can be accounted for. The log should be kept for a period as recommended by the local regulator, and in any event at least until after the relevant Hedge Fund's audit has been completed.

vii. The Hedge Fund manager should subsequently reconcile the prime broker's and administrator's records of positions against its own.

3.2 Non-Trading Transactions

The controls relating to the banking arrangements of a Hedge Fund are critical to the overall control of non-trading transactions undertaken by the Fund. Hedge Funds have the advantage of using prime brokers and administrators for their cash processing and as such can use the controls inherent in those service providers' systems as part of the control environment for the Hedge Fund. There are, however, key controls that are required by the Hedge Fund manager itself to enable non-trading transactions to be securely handled. The controls required for these transactions are different from those associated with trade processing as they need to cover subscription receipts, redemption payments, transfers, expenses payments and other free deliveries to third parties. The key areas of control are account opening, transaction authorisation, bank account reconciliation and investor transactions.

i. Bank account opening

a) The Hedge Fund itself should approve the opening of a new bank account for the Fund. The account opening documentation should include an authorised signatory list and appropriate limits on those authorisations and on the types of payment that may be made from the account.

b) The administrator will be responsible for issuing payment instructions and as such will be an authorised signatory and should provide up to date signatory lists. Free deliveries should require signatories independent of the Hedge Fund manager.

c) The Hedge Fund may delegate the authority to open executing broker accounts to the Hedge Fund manager. In this situation, the Fund should be regularly informed as to the full list of executing broker accounts opened.

ii. Transaction authorisation

a) All transactions should be authorised in accordance with the bank mandate.

b) The administrator should retain details of all Fund payments as a key record of bank transactions.

c) Wherever possible, standard settlement instructions should be used to reduce the risk of incorrect details on any payment.

d) At each month end the prime broker will post income and expense items to the prime brokerage account. These items will cover, amongst others, interest receivable and payable, stock loan fees and the financing cost of synthetic positions held. The Hedge Fund manager should have adequate systems to check the accuracy of these postings.

iii. Bank account reconciliation

a) The Hedge Fund's administrator and the Hedge Fund manager should reconcile their respective bank accounts on a regular, perhaps on a daily, basis.

b) All reconciling items should be recorded and resolved on a timely basis.

c) Valuations should not be issued unless all bank accounts have been satisfactorily reconciled.

iv. Investor transactions

a) The administrator will typically operate a bank account in the name of the Hedge Fund which is used for the receipt of subscriptions prior to the money being passed to the prime broker. In other cases, money may be paid into a segregated client account at the administrator prior to transfer to the prime broker.

b) The Hedge Fund manager should obtain records of net subscriptions and redemptions provided by the administrator. This will enable the Hedge Fund manager to monitor and manage its cash flow requirements. Hedge Fund managers should also familiarise themselves with the administrator's anti-money laundering procedures.

3.3 Portfolio Valuations

3.3.1 Pricing Policy

Procedures should be in place to allow investors to have a clear understanding of how the portfolio is priced and valued. This will vary between segregated accounts (where the Hedge Fund manager may provide valuations) and Hedge Funds (where the administrator should provide net asset value calculations). The key controls to be addressed are:

i. the valuation methodology should be clearly documented and included in the Hedge Fund's prospectus, if appropriate. In particular, how illiquid stocks are defined and valued should be disclosed. If investors are provided valuations by the administrator and estimates by the Hedge Fund manager, investors should be informed of the difference;

ii. Hedge Fund valuations should be performed by the administrator using independent pricing sources; and

iii. where a portfolio contains illiquid securities, or securities for which an exchange price is not readily determinable (such as, for example, unlisted securities, OTC securities etc) it is important to ensure that a pricing policy is in place that allows for the systematic, consistent and transparent valuation of such securities in a manner that does not impair the Hedge Fund manager's either actual or perceived independence in the process.

3.3.2 Valuation Reconciliations

Regular reconciliations should be undertaken to ensure that differences between service providers are swiftly resolved.

Regular reconciliations should be undertaken between the Hedge Fund manager, the prime broker and the administrator. The reconciliation should cover both cash and portfolio positions. For most Hedge Funds, it is likely that reconciliations will be undertaken daily with the prime broker and weekly or monthly with the administrator;

Differences should be resolved promptly and corrected in the appropriate system.

3.3.3 Control of Management, Performance and Administration Fees and Other Accruals

The calculation of performance, management and administration fees will typically be undertaken by the administrator. The Hedge Fund manager should have procedures and systems (independent of the administrator) in place to check these fee calculations and to enable the Hedge Fund manager to include realistic fee accruals into any intra-month net asset value reporting to investors.

The Hedge Fund manager should endeavour to monitor any other accrued income or costs, such as dividends payable, interest receivable or payable, audit fees, directors' expenses or any other significant costs.

3.3.4 Monitoring Investment Restrictions

Investment restrictions are intended to provide limits on a Hedge Fund manager's investment activity and as such to provide investors with an assurance as to the level of risk inherent in the manager's investment strategy. Hedge Fund managers must continually monitor the adherence to those restrictions.

i. Investment restrictions should be clearly stated in a Hedge Fund's prospectus. References to investment restrictions in other marketing material generated must be consistent with the prospectus;

ii. The restrictions should be sensible and realistic with respect to the relevant investment strategy and should comply with any regulatory requirements. Hedge Fund managers may set tighter restrictions in-house in order to have an early warning as to when the external restrictions are being approached;

iii. The restrictions should be regularly monitored by the Hedge Fund manager;

iv. The restrictions should be monitored on a timely basis to ensure that they are not breached at trade entry but, if this happens, the issues are identified and resolved promptly; and

v. Clear procedures should be documented to resolve any investment restriction breaches should they occur.

3.4 Managing Service Providers

Service providers' roles, responsibilities and liability should be clearly documented and their performance should be periodically reviewed and documented by the Hedge Fund manager.

The Hedge Fund manager should have regular contact with the service providers to establish good relationships, monitor and review information flows, deal with issues as they arise and continue to look for ways that the service providers can add value.

3.4.1 Prime Brokers

It is important that the Hedge Fund manager understands the role of the prime broker and, amongst other things, the cost, financing and securities lending structure, and also all material provisions of the prime brokerage documentation such as margin calls, synthetic products trading, segregation of assets, events of default etc.

The prime broker's functions will generally include:

i. clearing,

ii. custody,

iii. brokerage,

iv. margin financing (i.e. providing leverage),

v. reporting,

vi. stock lending and

vii. various value added services.

It is important when deciding upon a prime broker to consider not only the services the prime broker will provide but also how it will deliver them. Most processes should be automated between the delivery of information to the Hedge Fund manager and administrator. The Hedge Fund manager should expect to receive electronically at least daily portfolio, margin and cash reporting and should on a frequent basis review this information and raise any errors with the prime broker. Generally, the following factors should be considered in evaluating a prime broker and its documentation:

i. interest rate and fee structure,

ii. the prime broker's familiarity with and appropriate internal resources to service the investment strategy,

iii. the amount of leverage the prime broker is prepared to provide and the basis on which this is provided (e.g. the use of a risk-based system),

iv. extent of segregation and ownership of assets,

v. the exposure to the credit of the prime broker; and

vi. the value added services provided.

The Hedge Fund manager should seek confirmation from the prime broker that information furnished to its credit desk by the manager will not be shared with any trading personnel without the manager's consent.

3.4.2 Administrators

In addition to the Hedge Fund manager, the administrator is often the investors' main contact.

The administrator's functions will include:

i. co-ordinating opening bank accounts for the Hedge Fund,

ii. receiving and processing subscriptions and redemption requests,

iii. producing and reporting net asset value calculations,

iv. independent pricing and reconciliation of the portfolio,

v. computing and paying management and performance fees,

vi. acting as company secretary,

vii. preparing accounts,

viii. maintaining the shareholder register,

ix. arranging payment of dividends (if necessary) and redemption proceeds,

x. coordinating communications with investors, and

xi. implementing anti-money laundering procedures.

It is recommended that periodic reviews are performed of the services being rendered. This is sometimes best achieved by on-site visits with the administrator. In addition to regular reconciliation of trades with the administrator and the prime broker, the Hedge Fund manager should regularly monitor and review the net asset value calculation and other services, such as anti-money laundering procedures, performed by the administrator.

3.4.3 Brokers

A Hedge Fund manager may trade with multiple executing brokers and use the prime broker as settlement agent for the trades or it may use multiple prime brokers. Whilst many of the issues already referred to are equally applicable, the importance of the capture of the trade data by the administrator, cash management and the reconciliation processes involving the Hedge Fund manager are heightened due to the increased number of parties involved.

It is important that the Hedge Fund manager always knows by which executing broker and prime broker a trade is being handled.

It is also important that the appropriate bank and broker mandates are in place in order for cash movement between authorised brokers to take place.

3.4.4 Other Support Functions

The Hedge Fund manager is likely to outsource certain other business operations such as payroll processing, bookeeping and IT support. Service suppliers should be selected carefully to ensure that an adequate service is delivered.

3.4.5 Professional Advisers

Lawyers and/or accountants will be instructed in the set up process to advise on structuring the Hedge Fund, to produce the fund documentation, review service provider agreements and advise on other issues.

3.5 Information Systems and Business Continuity

3.5.1 Information Systems

There should be high standards of security and integrity over the computer systems that are used by the Hedge Fund manager. Such systems might include, inter alia:

i. order processing systems,

ii. portfolio management systems,

iii. risk management system,

iv. research systems, and

v. accounting systems.

The systems should be developed, implemented and maintained in a controlled manner. The existence of the different systems in use and their interaction should be documented. The systems used will vary between Hedge Fund managers depending on the size, investment strategy and volume of transactions being managed; it is for the Hedge Fund manager to determine the most appropriate systems required to manage the business. Inevitably, the operations of the Hedge Fund manager will be heavily dependent on the proper functioning of the systems and the integrity of the information produced by those systems. It is preferable if there are automated links between the Hedge Fund manager, the prime broker and the administrator. Systems infrastructure may be located in-house or outsourced to third party suppliers and therefore there will be differences in control procedures. However, the key controls that should be addressed are:

i. Core computer systems should be physically secure to prevent unauthorised access to the data processing area.

ii. Electronic access to the systems should be controlled and limited to authorised personnel. Access to different levels of the data processing systems should be protected by the use of readily changed passwords and other arrangements. These systems should be programmed to prevent and detect unauthorised access and any attempted breaches of security should be logged and appropriately followed up.

iii. Network file servers and computers should be protected by virus protection software. The internal network should be protected by a firewall against unauthorised access from external networks, including the Internet.

iv. The systems should provide a complete and accurate trail of transactions processed and appropriate procedures should exist for archiving, safe storage retention and retrieval of computer records. This would include daily, weekly and monthly back-ups of the system and off-site storage of back-up tapes.

v. Amendments to systems should be properly authorised, tested and documented. This will enable modifications to the systems to be implemented in a controlled manner. Often this process may be outsourced to a specialist firm and it is important that such a firm has the requisite skills to modify the systems.

3.5.2 Business Continuity

The Hedge Fund manager should develop a business continuity plan to cater for a disaster. This should allow for the recovery of all key operations at a disaster recovery site. The disaster recovery plan should include procedures for contacting key staff and access to back-up data stored off-site. The disaster recovery plan, including a full systems test, should be tested at least once per year. It is in the Hedge Fund manager's interests to ensure other service providers take similar care in this area.

4. Raising Capital and Investor Relations

4.1 Marketing

Raising adequate capital and attracting suitable investors is often one of the key determinants of the success of a Hedge Fund management business. When promoting their services and marketing the Hedge Funds whose investments they manage, Hedge Fund managers need to consider a variety of complex issues, including:-.

i. regulations on promotion and marketing;

ii. targeting and attracting investors;

iii. anti-money laundering;

iv. special agreements with investors;

v. adequate disclosure;

vi. timely disclosure of information; and

vii. disclosure to all investors;

These issues are discussed in more detail in this Chapter.

4.1.1 Regulations on Promotion and Marketing

Hedge Fund managers must be conscious of the regulatory restrictions that apply to promoting their services and marketing the Hedge Funds whose investments they manage. Hedge Fund managers may need to have regard to the regulations of several jurisdictions: where they operate, where they seek investors and the domicile of the Hedge Funds. Breach of these regulations can lead to severe consequences, including investor suits, fines, rescission rights and criminal sanctions as well as reputational damage.

In addition, Hedge Funds for which a listing on a stock exchange is sought may be subject to additional limitations on the type of investors who can invest and specific disclosures that must be made to these investors.

i. Promotion by the Hedge Fund manager. A Hedge Fund manager will generally require authorisation by the regulatory authority in the jurisdiction in which it is established and in which it operates. The local regulations will often restrict the manner in which the Hedge Fund manager may promote its services, including restrictions on the type of investors that may be contacted, the type of communications that may be made (including, for example, presentation of past performance or "track record") and legends that must appear in marketing materials. Use of publicly available media, such as the Internet, to promote the Hedge Fund manager's services will also be subject to restriction.

ii. Private and restricted offerings. In most jurisdictions, Hedge Funds may be offered on a private basis only. For example, the offering may be limited to a specified number of potential investors and/or to investors who meet certain threshold eligibility qualifications. The eligibility requirements may be based, among other things, on the investors' net assets or income, their own regulatory or professional investor status or their investment being at or above a certain amount.

iii. Registration of the marketer. If the Hedge Fund manager plans to market a Hedge Fund or its services, it may have to be authorised in the jurisdiction in which the marketing will occur or be directed. In some cases, the Hedge Fund manager may be able to "passport" in to another jurisdiction based on its regulatory authorisation in its home jurisdiction. If the Hedge Fund will be marketed by third-party marketers, the Hedge Fund manager should seek assurances that the third party marketer has all requisite regulatory approvals to conduct the marketing.

The complexity of applicable restrictions and the gravity of the consequences of their breach means that a Hedge Fund manager should consider the need to consult a professional adviser familiar with the laws of the local jurisdiction before undertaking any marketing. As these restrictions can seriously impact fund raising, this analysis should be undertaken early in the process of considering the launch of a new Hedge Fund manager or Hedge Fund.

4.1.2 Targeting and Attracting Investors

A balanced investor base is often a goal of the Hedge Fund manager as achieving this can help to minimise volatility, therefore bringing benefits to all investors.

A Hedge Fund manager should prepare a marketing plan to help focus on the type and scale of investors that it will seek to attract. This plan can also act as a key input into assessing the viability of a new venture and allow the Hedge Fund manager to reach a more objective judgement on potential investor requests for different terms and conditions. In establishing a Hedge Fund, consideration should be given to the structural preferences that the target investors may have.

There are various distribution channels available for a Hedge Fund manager to promote a Hedge Fund. Introductions by the prime broker and by the fund administrator can be part of the process of securing investment, and these may be utilised alongside other sources of investors.

4.1.3 Anti-Money Laundering

It is important that all those involved in promoting/distributing a Hedge Fund understand their role in preventing money laundering.

The Hedge Fund manager should ensure that a senior individual is responsible for money laundering and that all employees are kept up to date with developments in this area. The Hedge Fund manager should also ensure that appropriate procedures and controls are in place to ensure that the relevant rules and requirements are met particularly when marketing to potential investors. The Hedge Fund manager and Fund administrator have separate responsibilities in relation to money laundering.

4.1.4 Special Agreements with Investors ("Side Letters")

Individual investors may seek to maximise disclosures and/or negotiate preferential terms for their investment. In such circumstances the Hedge Fund manager should continue to attempt to treat all investors as equally as possible and continue to respect all legal and regulatory requirements. Agreeing to special terms may have significant legal consequences with long-term implications for both the Hedge Fund and the Hedge Fund manager. In addition, special terms agreed with early investors in a Hedge Fund can, as a business matter, hamper the Hedge Fund as it expands. In particular, "most favoured nation" provisions, by which an investor has a standing right to the best terms offered to any new investor, should be considered carefully in advance. Legal advice should be sought before agreeing to any such special conditions and side letters.

Alternative arrangements may also be made for investors to invest through managed accounts. Again, the Hedge Fund manager should consider carefully both its ability to

meet any special requirements and terms and the impact that any such arrangements may have on other clients and or investors.

4.1.5 Adequate Disclosure

Hedge Fund managers should provide adequate disclosure of information to investors on a consistent and timely basis. The following suggests the key objectives that disclosure to investors should aim to achieve:

i. information provided to investors should be prepared on a consistent basis and be presented in a clear manner. Where significant assumptions have been used in preparing the information, these should be clearly explained and consistently applied;

ii. as far as possible Hedge Fund managers should advise investors before they invest of the form, content and timing of regular information that will be communicated to them;

iii. portfolio information should be provided to investors on a periodic basis and should allow investors to determine, in summary form, how accounts are invested;

iv. performance information should be made available to investors to allow investors to understand how an account has performed. The Hedge Fund manager will be crucial to preparing this information, although the administrator may help facilitate the provision of this information to investors in a Hedge Fund; and

v. exceptional disclosures should be made to investors if there have been significant changes in how an account is managed, changes to key investment personnel and any major changes in the infrastructure of the Hedge Fund manager and or service providers to the account.

4.1.6 Timely Disclosure of Information

Disclosure to investors should be made as soon as reasonably practicable, bearing in mind the need to protect all investors' interests and any applicable legal or regulatory constraints. Often the Hedge Fund will be subject to regulatory requirements that mandate the production of accounts or other information, an independent audit, and their filing with relevant regulatory authorities within a certain time period. The Hedge Fund manager should be aware of these requirements and may wish to monitor compliance with them though it has no legal obligation to do so.

i. regular communication to investors should take place and a Hedge Fund manager should aim to complete this communication promptly after the net asset value is finalised;

ii. the Hedge Fund manager or administrator should maintain an up to date investor contact database to facilitate the effective and timely distribution of important information; and

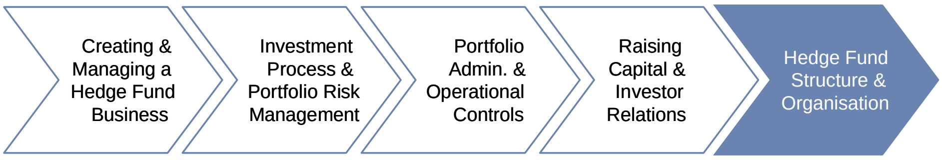
iii. if a Hedge Fund manager has important disclosures to make and wishes to do so by telephone or in person, the manager should aim to organise itself in such a way as to endeavour to complete all investor contact as soon as practicable.

4.1.7 Disclosure to all Investors

The Hedge Fund manager, as far practical, should aim to disclose information about material items and changes to all investors who will be affected by such items and changes.

i. A Hedge Fund manager should seek not to differentiate communications to investors either in terms of the nature, content, manner or timing of disclosures, except as justified by the different relevance of the communication to the investors.

ii. Investors should be able to direct questions to a small number of key personnel at the Hedge Fund manager and expect a timely response to questions irrespective of the size of their investment. A Hedge Fund manager should devote adequate resources to responding to investor queries (made either directly or through the administrator).



5. Hedge Fund Structure and Organisation

Whilst the foregoing chapters have focused largely on sound practices in connection with Hedge Fund managers, this chapter summarises various sound practices with respect to Hedge Funds.

It should be noted that because Hedge Funds take many different forms and structures and vary with respect to type and complexity of investment strategy and products traded, some of the sound practices outlined in this chapter may include items more relevant to some Hedge Funds than to others.

A Hedge Fund's structure should be based on a realistic assessment of the needs and preferences of its anticipated core investors. Careful analysis in the initial structuring of the Hedge Fund can help avoid delay and further expense spent in restructuring the Hedge Fund at a later date.

Investors are likely to have certain expectations and preferences before they invest in a Hedge Fund, including:

i. whether the Hedge Fund is established in a jurisdiction that is familiar to them and is tax neutral;

ii. whether the Hedge Fund is established in a particular form (e.g., company, limited partnership, unit trust or civil law equivalents);

iii. the structure's tax consequences for the Hedge Fund and the investor;

iv. the extent and frequency of reporting (financials and/or investor updates from the Hedge Fund manager);

v. the frequency of and any limitations on dealing (subscriptions and redemptions and minimum investment amount);

vi. the level of management and performance fees;

vii. the investment strategy, anticipated leverage, risk profile, investment restrictions; and

viii. whether or not the Hedge Fund is listed.

In structuring a Hedge Fund consideration should also be given to retaining enough flexibility to accommodate any contemplated expansion in the type of investors being targeted.

5.1 Structure of the Hedge Fund

Typically, a Hedge Fund is sponsored by its manager or its marketeer. The sponsor should plan the structure of the Hedge Fund in consultation with the Hedge Fund's proposed marketeer and manager (if different from the sponsor) and professional advisers, having regard to the above considerations.

5.1.1 Legal Structure of the Hedge Fund

A Hedge Fund will normally be a separate legal entity from the Hedge Fund manager. Hedge Funds may be structured in a variety of forms, including limited companies, limited partnerships and unit trusts (or their equivalents in civil law jurisdictions). Hedge Fund structures often accommodate more than one of these forms using "master-feeder" structures.

i. Hedge Fund domicile

Hedge Funds may be established in any jurisdiction that has suitable legal provision for the formation of the proposed investment vehicle and its business.

The domicile ultimately selected for the Hedge Fund should be determined by weighing several factors:

(a) the amount of regulation and taxation imposed in the proposed jurisdiction, the time required to gain local regulatory approval and the flexibility of local regulation;

(b) formation costs and ongoing expenses (e.g., annual registration costs);

(c) service provider requirements and the availability and quality of local service providers;

(d) jurisdiction of targeted investors and their familiarity with and preferences concerning the Hedge Fund's domicile;

(e) the Hedge Fund manager's domicile and its familiarity with the Hedge Fund's domicile; and

(f) any difficulties arising from the remoteness of the proposed jurisdiction (e.g., timezone differences).

Jurisdictions vary as to the extent of their receptivity to Hedge Fund structures. In addition, the location of the Hedge Fund manager may have an impact on any regulation applicable to the Hedge Fund. The sponsor should consult with appropriate experts in determining the Hedge Fund's domicile.

i. Taxation issues

A Hedge Fund should be structured and maintained so as to preserve its tax neutrality. Different structures may have different advantages for different investors. Expert legal and tax advice should be taken at the outset to ensure that the activities of the Hedge Fund (including its directors and its Hedge Fund manager) do not prejudice its tax status.

ii. Listing

A Hedge Fund should obtain expert advice to determine whether and, if so when, it should seek to list some or all of its shares on a recognised stock exchange. Whilst the purpose of listing would not generally be to create an active secondary market (liquidity is provided by the Hedge Fund itself through the redemption facility), it could serve several useful purposes, including:

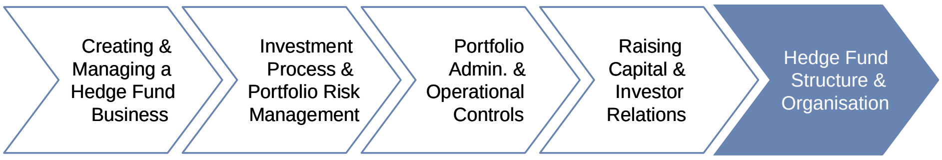
(a) allowing the Hedge Fund to participate in certain securities issues it would not otherwise have been eligible for (i.e. hot issues)

(b) opening the Hedge Fund to investors that are restricted from investing in unlisted securities; and/or

(c) opening the Hedge Fund to investors that require an additional level of comfort that the Hedge Fund is subject to more stringent regulations and requirements than it would otherwise be in its domicile.

However, advice should be obtained on the additional costs associated with the listing, continuing obligations and any additional investment restrictions. In particular, listing after launch may require the preparation and filing of audited accounts and involve other costs.

iv. Multiple classes and ring fencing



If the Hedge Fund will be trading identifiably distinct strategies, it should consider establishing separate sub-funds through which each strategy is traded. Certain jurisdictions permit the creation of sub-funds that are legally segregated, so that losses of one sub-fund should not have to be paid from the assets of another. If the nature of the Hedge Fund's trading makes such "contagion" a significant concern, then consideration could also be given to forming subsidiary companies of the Hedge Fund through which trading would be done in order to "ring fence" the liabilities associated with such trading in the applicable subsidiary.

5.1.2 Prospectus and Material Contracts

The directors of the Hedge Fund should approve in a formal meeting the prospectus, offering memorandum or other disclosure documents and all material contracts to be entered into by the Hedge Fund.

Material contracts would typically initially include:

i. Memorandum and Articles of Association or Limited Partnership Agreement;

ii. Administration Agreement with the Hedge Fund's Administrator;

iii. Prime Brokerage Agreements with the Hedge Fund's Prime Broker; and

iv. Investment Management Agreement with the Hedge Fund manager.

The Hedge Fund's prospectus should provide disclosure to potential investors adequate for them to make an informed investment decision, including material risks, material aspects of the valuation methodology, liquidity and the investment objectives, strategy and restrictions. Marketing material should be in line with this information.

Supplemental disclosures should be made in respect of material changes in any of the above.

The directors should affirmatively take responsibility for the statements in the prospectus. The directors should closely review the prospectus and as appropriate consult with the Hedge Fund manager, administrator, prime broker, lawyers and auditors, with the aim of making adequate disclosure.

5.1.3 Appropriate Professional Advice

In evaluating its organisational structure, the advice of lawyers and accountants with experience in the tax and financial services regulations relevant to Hedge Funds, the jurisdiction and rules applicable to the Hedge Fund manager and their investments should be sought.

5.1.4 Directors

Other than Hedge Funds organised as unit trusts/FCPs, Hedge Funds are controlled by directors either of the Hedge Fund itself, if organised as a company, or of the Hedge Fund's corporate general partner, if organised as a limited partnership. Directors should consist of natural persons rather than corporate entities. The directors should have relevant standing and experience to allow them to discharge their fiduciary and other duties. The directors should be prepared to act in the interest of the investors.

(Hedge Funds organised as unit trusts are controlled by a trustee. Generally, the responsibilities outlined in this chapter for directors will fall on the trustee of such Hedge Funds.)

i. Taxation consequences of Board Composition and Meetings

When selecting directors, consideration should be given and appropriate professional advice sought as to the taxation consequences to the Hedge Fund resulting from the residence and domicile of each of the directors and the location of directors' meetings.

ii. Substantive Board Meetings

Directors should meet at least quarterly in minuted board meetings in a regular location which does not itself give rise to tax or regulatory issues for the Hedge Fund. Formal agendas and board reports should be prepared in advance and the Hedge Fund manager should report on the Hedge Fund's strategy, performance and compliance with investment objectives. The directors should also periodically be presented with reports on the performance of all of the Hedge Fund's counterparties and service providers. Audited financial statements should be approved on an annual basis. Minutes should be retained at the Hedge Fund's registered office.

5.2 Independent Service Providers

The Hedge Fund should appoint relevant reputable and experienced service providers. The Hedge Fund's service providers and their proposed contracts with the Hedge Fund should be reviewed and approved by the directors. In addition, once these service providers have been appointed, the Hedge Fund should make appropriate and timely use of its service providers' resources and expertise. In addition to the Hedge Fund manager, among the service providers that the Hedge Fund should appoint and monitor are an administrator, prime broker (where appropriate to its business), custodian (where separately required by the law of its domicile), auditors and lawyers.

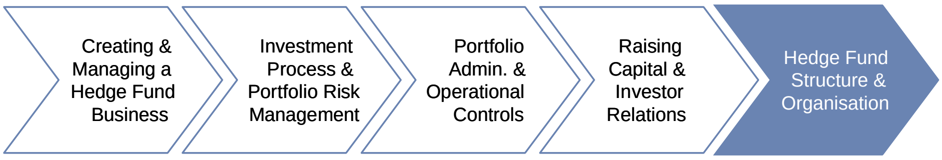
It is important at the beginning of each relationship with a service provider that the Hedge Fund's requirements are identified and documented. Appropriate due diligence should be carried out, generally by the Hedge Fund manager or his professional advisers on the Hedge Fund's behalf, prior to starting the business relationship (which may include face-to-face meetings with and office visits to the service provider). Once service providers have been retained, the directors should take reasonable steps to ensure that they and the Hedge Fund manager monitor the performance of all service providers and ensure that there is regular communication.

The directors should ensure that all service providers (including the Hedge Fund manager) have standing and expertise appropriate to their function for the Hedge Fund. As far as possible the flow of portfolio information within the "triangle" of the administrator, prime broker and Hedge Fund manager should be automated (often referred to as the "triangular reconciliation process").

5.2.1 Hedge Fund Administrator

The Hedge Fund should select an administrator that has the experience and resources to provide satisfactory services to the Hedge Fund. Specifically, the administrator should have experience in accounting for and valuing the products traded by Hedge Funds with similar investment strategies.

Investors may establish contact with the Hedge Fund through the administrator. The directors should bear this investor relationship role in mind when appointing the Hedge Fund's administrator.



5.2.2 Prime Broker(s) and Custodian(s)

The prime brokerage documentation typically will be highly complex and should be reviewed by a lawyer familiar with these arrangements. The directors should ensure that they and the Hedge Fund manager fully understand the prime brokerage arrangements and the risks inherent in it.

An independent custodian may be required in some jurisdictions, in which case advice should be sought on the ability of the custodian to appoint the prime broker as a sub-custodian.

5.2.3 Auditors

The directors, working together with the administrator, should be able to provide timely audited accounts to investors at least annually. The Hedge Fund should retain appropriately qualified external auditors that have experience with Hedge Funds generally and are familiar with the specific types of trading and instruments contemplated by the Hedge Fund manager. The Hedge Fund's jurisdiction may also impose certain requirements with respect to auditors. The directors should annually review the engagement of the auditors.

5.2.4 Lawyers

A Hedge Fund should appoint legal counsel in appropriate jurisdictions, including where the Hedge Fund is domiciled and where the Hedge Fund manager is located and operates.

5.2.5 Hedge Fund Manager

The Hedge Fund manager's services should be governed by a written agreement that specifically sets out the investment restrictions and investment policies of the Hedge Fund (by cross-reference, if appropriate, to the Hedge Fund's prospectus), as well as the fees to be paid to the Hedge Fund manager. Whilst the Hedge Fund manager may need to monitor other service providers to Hedge Funds, in order to maintain its reputation, the Hedge Fund manager should act as a service provider to the Hedge Fund rather than as its controller. This may be particularly important from a tax perspective.

Appendix 1 - Working Group

Co-ordinator: Segun Aganga
Goldman Sachs (Prime Brokerage)

	Managers	
1	Adelphi Capital Limited	Nick Tyler
2	Ailsa Capital Management LLP	John Thomson
3	Alternative & Derivative Investments	Alain Reinhold
4	Avocet Capital Management Limited	Paul Mack
5	Centaurus Capital Limited	Paul Leary
6	Henderson Global Investors	Sarah Speake
7	Jupiter Asset Management Limited	Kevin Meehan
8	Kairos Group	Raymond Bugeja
9	KiCap Management Limited	Luc Huyghebaert
10	Lansdowne Partners Limited	Paul Ruddock
11	Marble Bar Asset Management LLP	Simon Luhr
12	Pendragon Capital LLP	Gordon Lawson
13	Powe Capital Management LLP	Raza Khan
14	Voltaire Asset Management Limited	Laurent Condon
	Accountants	
15	Ernst & Young	Ratan Engineer
16	Deloitte & Touche	David Logan
17	PricewaterhouseCoopers	Graham Phillips
	Administrators	
18	Citco London Limited	John Verhooren
19	Fortis Fund Services (Ireland) Limited	Philip Craig
	Compliance Consultants	
20	IMS Consulting Limited	Scott Wilson
21	Leale-Green Ltd	Alan Leale-Green
	Lawyers	
22	Dechert	Peter Astleford
		Bertrand Fry
23		
24	Simmons & Simmons	Iain Cullen
	Prime Brokers	
25	Goldman Sachs	Daniel Harris
		Graham Jung
		Donald Pepper
26	Morgan Stanley	Deborah Thompson
		Martin Byman
		Philippe Riachi
	Investor	
27	Fauchier Partners Limited	Christopher Fawcett
	Industry Association	
28	The Alternative Investment Management Association Limited	Emma Mugridge
		Florence Lombard
		Mary Richardson