MFA Reporter

March 2004

Reporting on issues for investment professionals in futures, hedge funds and other alternative investments

Inside This Issue

MFA in Washington 3
By John G. Gaine, MFA President, and Stephanie Miranda Pries, MFA Vice President and Senior Legal Counsel

Absolute Return Money Management: A Future Perspective 5
By Timothy Straus, CEO, StoneHedge Partners, Inc.

Risk Management Lessons in Leveraged Futures Trading 7
By Hilary Till, Portfolio Manager and Co-Founder, Premia Capital Management, LLC

Are Hedge Funds Secure? 9
By Bob Pollock, CEO, & Sean Chumura, CTO, CoSolutions Systems, Inc.

NASD Issues Interpretive Guidance On Hedge Fund Sales Materials 10
By Michael P. Malloy, Partner, Drinker Biddle & Reath LLP

MFA on Accounting: A New Way to Save for Health Care 16
By Margaret Sheridan and Scott S. Anderson, CPA, Arthur F. Bell, Jr. & Associates, L.L.C.

PR News and Reviews 17
By Meg Bode, MFA PR Consultant

MFA Member News 20

Press Check 21

Managed Funds Association

Summary of Remarks at MFA Seminar, "Valuation Challenges for Hedge Funds"

By Timothy P. Selby and Manuela A. Cattaneo, Cadwalader, Wickersham & Taft LLP

MFA successfully hosted the second educational seminar of its current series in the wake of a snowstorm that nearly crippled New York City on January 28th. Despite the weather, MFA saw high attendance at the seminar on "Valuation Challenges for Hedge Funds", where three panels of industry experts discussed issues associated with valuation policies and procedures for hedge fund managers. The panelists covered three topics: (i) sound valuation policies and procedures and how they are implemented in practice, (ii) the challenges faced with valuing difficult-to-value investments, and (iii) the accounting principles that should be observed in connection with portfolio valuation and the hedge fund manager's disclosure obligations with respect to its valuation practices. Below is a summary of the more pertinent issues discussed during each panel session.

> *The panelists asserted that hedge fund managers should clearly establish consistent, reproducible, simple, transparent and verifiable valuation methods to be used for portfolio positions that are difficult-to-value, or illiquid.*

Session 1: Sound Valuation Practices

Sandy Fleischman, Lehman Brothers; Kenneth Grant, EXIS Capital Management; Kenneth Raisler, Sullivan & Cromwell

The first panel discussed the role of prime brokers, auditors and pricing services in

continued on page 2

Valuation Challenges for Hedge Funds

continued from page 1

establishing proper check-and-balance procedures for valuing a hedge fund's investments. The panelists also discussed how to resolve discrepancies between valuations provided by prime brokers and those produced internally by the hedge fund manager. Each panelist emphasized that discrepancies should be investigated and that alternative valuation methods or services may need to be considered in order to resolve any discrepancies. There was a general consensus among the panelists that the more complicated or illiquid the securities, the more necessary it will be to assure investors that strong control procedures are in place. In addition, it was recommended that hedge fund managers avoid holding assets that they cannot comfortably value.

The panelists asserted that hedge fund managers should clearly establish the valuation methods to be used for portfolio positions that are difficult-to-value, or illiquid. Such methods should be: consistent, reproducible, simple, transparent and verifiable. The panelists discussed the fact that a hedge fund manager's investment valuations serve two distinct purposes – risk monitoring and NAV determination for subscription and redemption purposes. The panelists believed that generally speaking the same valuation methodology should be used for both purposes, except that adjustments may be appropriate when using valuations for risk monitoring purposes in order to reflect particular risk factors (e.g., concentration risk) or to assess a fund's exposure to certain unexpected events (e.g., disaster scenarios).

The panelists stated that it was absolutely necessary for hedge fund managers to be prepared to provide explanations to the fund's external auditors and to provide investors with adequate disclosure in the fund's financial statements and offering documents. The panelists expressed some concern regarding the smaller hedge fund's ability to address conflict of interests and separation of function issues in the valuation arena. The panelists also discussed whether senior management should be involved in the valuation process. Valuation procedures, according to the panel, will vary depending on the complexity of the strategy employed, the markets covered and the amount of assets under management. However, all panelists agreed that hedge fund managers should either calculate or verify the accuracy of prices independent of the trading function.

Frequent reference was made to the usefulness of the MFA's *2003 Sound Practices for Hedge Fund Managers* on the subject of valuation. The panelists observed that valuation practices in the industry have significantly improved since Long Term Capital Management and the initial publication of *Sound Practices for Hedge Fund Managers* in February 2000. Finally, the panelists expressed their belief that the development and promotion of industry sound practices would be a more effective means of enhancing hedge fund valuation practices than increased SEC regulation.

Session 2: Valuation of Illiquid and Complex Products

Kevin Mirabile, Barclays; Gerald Beeson, Citadel Investment Group; Sarah Payne, Credit Suisse First Boston; Laurence Penn, Ellington Management Group, LLC; Charles Smithson, Rutter Associates; Todd Streichler, GlobeOp Financial Services LLC

During the second session, a panel of hedge fund executives,

continued on page 12

MFA Reporter is the newsletter of Managed Funds Association. Its purpose is to publish the most useful and timely news and ideas from knowledgeable industry professionals.

MFA
Holly Singer, Editor
Communications Committee
2025 M Street, N.W., Suite 800
Washington, DC 20036-3309
Tel.: 202.367.1140 ■ Fax: 202.367.2140
Web site: www.mfainfo.org

Reproduction by any means of the entire contents or any portion of this publication without prior permission is strictly prohibited. This publication is designed to provide accurate and authoritative information to MFA members in regard to the subject matter covered. The articles contained herein are the opinions of the individual authors and do not constitute the rendering of legal, accounting or other professional advice. If legal or other professional assistance is required, the services of a competent professional should be sought.

© 2004 Managed Funds Association. All rights reserved.

MFA in Washington

By John G. Gaine, MFA President, and Stephanie Miranda Pries, MFA Vice President & Senior Legal Counsel

MFA is pleased to provide Members with the following summary of the numerous legislative and regulatory issues we are addressing this spring. MFA continues to monitor developments at the Securities and Exchange Commission (SEC) regarding potential changes to hedge fund regulation. MFA submitted its comment letter to the SEC on proposed Regulation SHO and the "Married Puts Release." MFA has also submitted a comment letter to the National Association of Securities Dealers Regulation (NASD) to oppose their proposal to rescind their policy allowing trail commissions used by brokers who sell interests in public commodity pools. Finally, MFA continues its outreach to the alternative investment industry through its own events and other industry conferences. These initiatives are discussed below. If Members would like information on any of the proposed rules or comment letters discussed in this article, please visit MFA's Web site at ***www.mfainfo.org*** or write to MFA via e-mail at ***hq@mfainfo.org***.

MFA welcomed the remarks by Chairman Greenspan asserting that no more regulatory oversight is required for hedge funds.

MFA Continues to Monitor the SEC's Recommendations to Change the Regulation of Hedge Fund Managers

MFA has continued its efforts to oppose one key recommendation set forth in the Securities and Exchange Commission's (SEC) staff report, *Implications of the Growth of Hedge Funds.* As stated in prior issues of the *MFA Reporter*, MFA opposes the SEC staff recommendation for mandatory registration of all hedge fund advisers for a variety of reasons. We do not believe that mandatory registration is necessary given the high degree of sophistication of investors in hedge funds, that such a requirement would not successfully deter fraud, and this recommendation would divert scarce SEC resources better reserved to protect retail investors in mutual funds. These arguments have been articulated before policymakers in Washington, to the press, and in MFA's comment letter to SEC Chairman William Donaldson submitted last November.

MFA believes that before any changes to the current regulatory framework governing hedge funds are made, Chairman Donaldson and Congress should have the benefit of input from the Presidents Working Group on Financial Markets (PWG). The PWG consists of four members: the SEC Chairman, the Chairman of the Commodity Futures Trading Commission (CFTC), the Chairman of the Federal Reserve System and the Secretary of the Treasury, who is the Chairman of the PWG. On February 12, Federal Reserve Chairman Alan Greenspan, during the course of his testimony before the Senate Banking Committee, objected to this particular SEC recommendation and stated his belief that hedge funds play an important role in providing market liquidity and in contributing to the flexibility of the international financial system. MFA welcomed the remarks by Chairman Greenspan asserting that no more regulatory oversight is required for hedge funds. The SEC staff responded to Chairman Greenspan's remarks stating that the Commission staff does not believe that their recommendation would impede the manner in which hedge funds operate.

Chairman Donaldson still lacks the support of the two other Republican SEC Commissioners, Paul Atkins and Cynthia Glassman. Recently, Commissioner Glassman reiterated her objection to this recommendation for mandatory registration at a conference in London on February 17. Despite the public opposition by the Federal Reserve Chairman, CFTC Chairman James Newsome, and SEC Commissioners Atkins and Glassman, Chairman Donaldson continues to seem to support the staff's recommendation. Nevertheless, MFA will continue its efforts to oppose this push for mandatory registration of all hedge fund managers. MFA will keep Members informed about any developments on this issue.

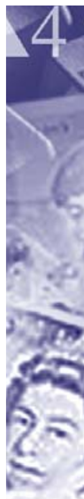
continued on page 4

continued from page 3

MFA Submits Comment Letter to the SEC Regarding Its Proposed Rule on Short Sales

On January 29th, MFA submitted a comment letter to the SEC on the Securities Exchange Act release, "Proposed Rule: Short Sales" ("Regulation SHO") (published on October 29, 2003). In this letter, MFA also addressed issues raised in the Securities Exchange Act interpretive release on Married Puts (published on November 17, 2003). Proposed Regulation SHO would revise the current rules applicable to the practice of short selling under the Securities Exchange Act of 1934. The "Married Puts Release" is intended to close a loophole in the so-called "uptick rule."

Our comments to the SEC first extolled the benefits of short selling to the broad financial marketplace. MFA regards short selling as an "essential method by which investors … can register their view that the current price of a security diverges from the value ascribed by the investor." MFA supports the SEC's efforts to modernize regulations governing short sales. In our letter, we applauded the SEC's willingness to suspend the current short sales rules for large capitalization stocks. The letter then focused on ways that Regulation SHO should be improved before the SEC adopts it as a final rule.



> *MFA regards short selling as an "essential method by which investors … can register their view that the current price of a security diverges from the value ascribed by the investor."*

The January 29 letter provided a detailed critique of Regulation SHO and explained why we believe certain provisions should be amended. Particular areas of Regulation SHO that we believe should be amended were the "bid test," locate and delivery requirements, among many others. For instance, with respect to the "bid test" proposed in Rule 201(b) of Regulation SHO, MFA believes that the test "is not appropriate and would be dysfunctional." We state that the proposed requirement for a one-cent pricing increment over the prevailing best bid should not apply in rising markets as that it would "impede trading and distort market pricing." In our letter, we recommended that the SEC consider adopting the alternative put forth by the SEC in the release accompanying Regulation SHO, that is, "a bid test allowing short selling at a price equal to or above the consolidated best bid if the current best bid is above the previous bid (i.e., an upbid)."

MFA also critiqued the proposed "locate and delivery requirements" for short sellers in Rule 203 of Regulation SHO. Under this proposal, it appears that if an investor effects a short sale and there is a subsequent delivery failure, the investor would be penalized. We stated that, "while we understand the [SEC's] objective of protecting against collusive shorting … we do not believe that purpose is served by penalizing an investor who might not be at all responsible for his or her brokerage firm's failure to deliver." MFA recommended in the January 26 letter that the SEC reconsider its approach to the "locate and delivery" issue especially in light of the unintended consequences of the proposed requirements, as explained in our letter.

Our final comment addressed the "Married Put Release" recommending that the SEC codify the release and incorporate it into the new Regulation SHO "with clearly articulated, objective tests." As merely an interpretative release, the "Married Puts Release" raises a number of questions that should be resolved through formal rulemaking. For example, MFA pointed out that it is not clear "what combinations of financial instruments, beyond married puts, would be subject to the six-factor test set forth in the Married Put Release." Our position is that such "subjective or imprecise tests should have no place with respect to guidance" concerning married puts.

The January 26 letter critiqued many other aspects of Regulation SHO including the regulation of trades that do not print in the U.S., the proposed test for aggregation of units, exemptions for "bona fide arbitrage," and merger arbitrage exceptions. We encourage Members to review these extensive comments on the MFA Web site. MFA plans to reach out to the SEC staff to discuss our recommendations to improve Regulation SHO and to encourage the SEC to move expeditiously toward the complete removal of short sale price regulation.

continued on page 15

Absolute Return Money Management: A Future Perspective

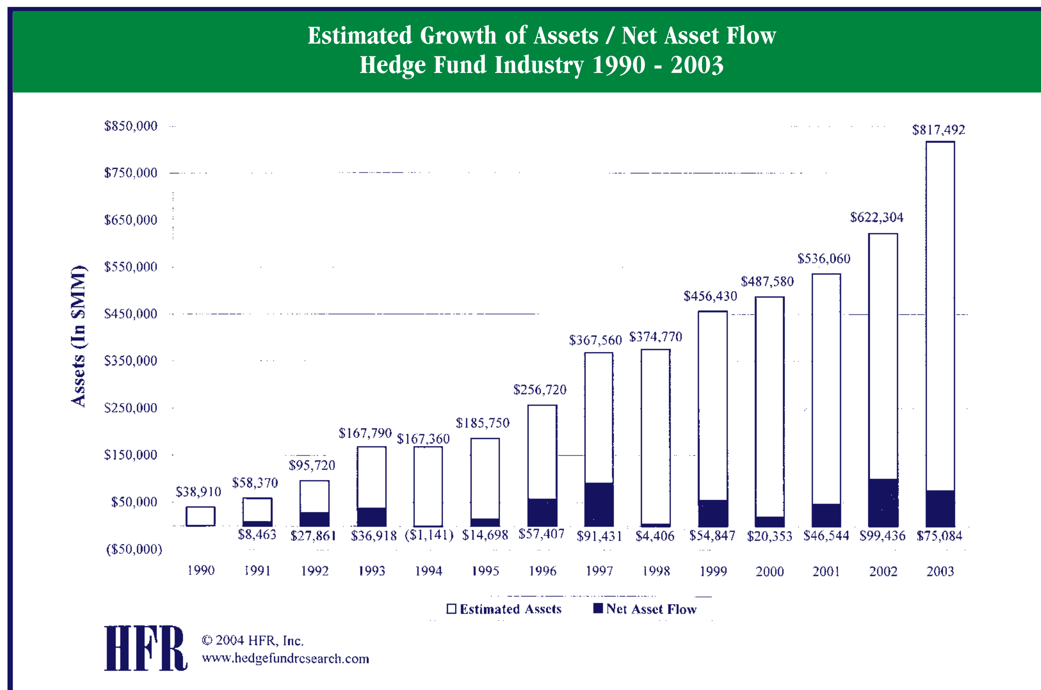
By Timothy Straus, CEO, StoneHedge Partners, Inc.

We are in the early stages of a paradigm shift in the way institutional money, particularly equities, will be managed in the U.S. and around the world. Similar shifts have occurred before and have usually been associated with three underlying events: 1) an equity bear market, 2) legislative initiatives, and 3) the failure of the existing dominant money management methodologies. There is perhaps one more important component of these significant shifts in how institutional assets are managed — that is, that the new management infrastructure must be mature enough and deep enough to effectively be the recipient of substantial financial asset shifts. The accelerating awareness and use of absolute return strategies such as hedge funds will have a major impact as a challenge to the existing institutional money management paradigm.

Historical Evolution of Institutional Money Management

Prior to the bear market of 1973-74, whether it was for "institutional" or high net worth individuals, large fiduciary institutions, dominated by banks and trust companies, managed the majority of financial wealth in the world. The bear market unveiled the ineffective and in many cases disastrous methods employed by these managers at that time, which led to the explosion of the myth of the "nifty fifty." The belief at that time was that desired returns could be achieved by investing in only these 50 or so larger capitalization stocks. These stocks were in effect believed to be the "holy grail" of investment and, as a result, they attained price to earnings multiples that were not seen again until the 1999-2000 bull market highs. The results in both cases were the same – massive losses in capital driven by an unshakable belief in the efficacy of a flawed investment philosophy.

At that same time, significant legislative reforms were about to be undertaken with the Employee Retirement and Income Security Act of 1974 (ERISA) that led to the creation of a new industry: non Trust/Bank investment management. ERISA was legislated particularly because of the rising chorus of concerns that funds of private pension plans were being mismanaged and seriously abused, as evidenced by sub-par performance during the period leading up to and following the passage of ERISA. The combination of all of these events, the bear market, legislation, and the failure of the existing money management philosophy, led to the explosive growth in assets of ERISA pension fund managers. This was shortly followed by legislation, which resulted in individual retirement money ballooning assets of the mutual fund industry creating an even larger pool of investable assets. This combination of events also led to the rapid decline of bank and fiduciary trust companies as the dominant players in the money management industry.



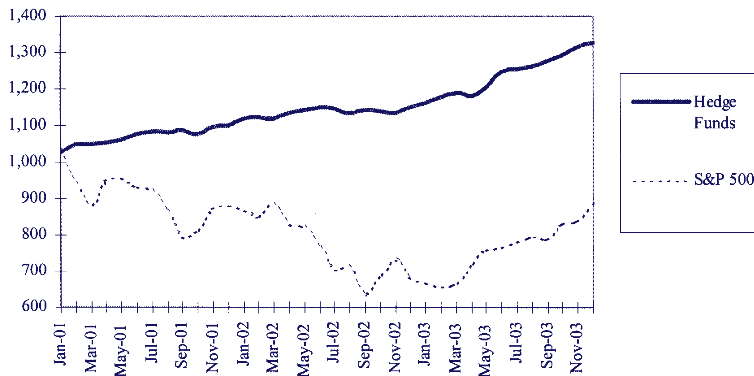
Today we have experienced a healthy and totally normal rebound from the capital

continued on page 6

Absolute Return Money Management

continued from page 5

Cumulative Return 2001-2003



Source: PerTrac 2000. Cumulative return for 1500 hedge funds with inception prior to January 2001 - data provided by Hedgefund.net.

destruction that started with the equities bear market in March of 2000. This was a direct result of implosions in the technology and Internet stocks, where multiples reached levels of irrationality not seen in our lifetimes. The resultant loss of wealth will likely take many years to recapture despite the recent rally in stocks. There is, because of this debacle, a justified, general mistrust of the financial management infrastructure, just as there was following 1974.

The true nature of the beast was simply that the methodology and generally accepted practices of the money management industry as a whole were intrinsically prone to fail investors. It was not the result of the relatively small pocket of abusers that then, as now, received the bulk of media attention. Nor was the cause of the 1999-2000 "bubble" market the result of individual speculation. The majority of capital flowing into the largest capitalized stocks with stratospheric multiples to earnings was, in fact, institutional money, which provided the speculative umbrella for individuals to be sucked into the feeding frenzy.

Pitfalls of Relative Performance and Long-Only Strategies

The real problem is the way money has been traditionally managed in the pension and mutual fund industries, which have a very significant overlap. Interestingly, most pension managers also manage mutual funds; they just market and charge differently. This affects defined benefit and defined contribution plans equally, in that the current process is by definition inefficient, prone to herd mentalities and consists of far higher risk-taking than should be prudently taken. The idea of "relative performance" or "benchmarking," which are creations/fictions of the consulting community, itself feeding from the same trough as the investment managers, are ultimately tools for the rationalization of excessive risk taking. The oft-quoted phrase "you can't eat relative performance" is a truism only because it is a fact.

Does anyone really think that they have achieved a positive outcome because the managed pool of financial assets that has been allocated by pension advisors and consultants was down only 20% when the benchmarks were down 25%? Yet the blame does not lie with equity performance benchmarks, the blame lies with the inefficiencies of allowing our enormous pension and retirement wealth to be managed by long-only strategies. These strategies are usually overly concentrated in each style by the absolute need to perform in line, or slightly beat the benchmarks upon which those managers are assessed. This clearly results in the need for most of these managers to chase the same so-called "market capitalization" performance leaders. More importantly, it forces managers to be fully invested and have extremely limited cash balances - even as a bear market trend becomes obvious and the need for cash becomes imperative.

We had the bear market. Can anyone doubt that we have also had the obvious failure of the existing dominant money management methodology? At the same time, it is increasingly likely that we will have legislative actions on a number of fronts. The existing paradigm is being challenged, and rightfully so. Nevertheless, is there a mature enough financial management methodology that can absorb significant money flows to provide an effective, efficient alternative to the financial management infrastructure that existed over the past 30 years? There is and it is called "absolute return money management," mainly considered the realm of hedge funds.

continued on page 14

Risk Management Lessons in Leveraged Futures Trading

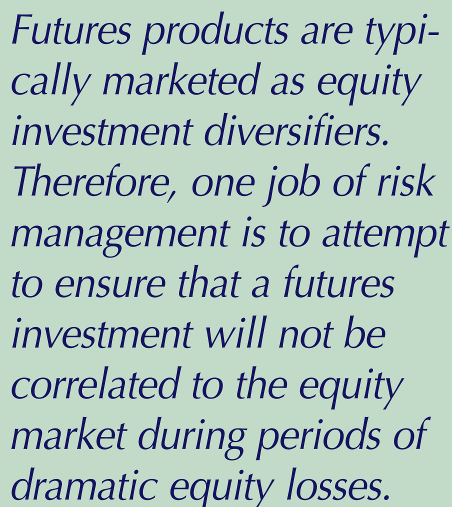
By Hilary Till, Portfolio Manager and Co-Founder, Premia Capital Management, LLC

Author's Note: This is an updated version of an article which was originally published in the September 2002 issue of Commodities Now.

This article will briefly discuss the practical issues involved in applying a disciplined risk-management methodology to leveraged futures trading. If a portfolio of instruments is normally distributed, one can come up with a 95% confidence interval for the portfolio's change in monthly value by multiplying the portfolio's recent monthly volatility by two (or 1.96, to be exact.)

The measure is useful because one wants to ensure that under normal conditions, a futures position has not been sized too large that one cannot sustain the random fluctuations in profits and losses that would be expected to occur, even without a dramatic event occurring.

While Value-at-Risk is indeed useful, it still has to be used jointly with other measures and actions. Using long-term data, one should also directly examine the worst performance of a commodity trade under similar circumstances in the past. In practice, we have found that such a measure will sometimes be larger than a Value-at-Risk measure based on recent volatility.



Futures products are typically marketed as equity investment diversifiers. Therefore, one job of risk management is to attempt to ensure that a futures investment will not be correlated to the equity market during periods of dramatic equity losses.

A commodity investment manager can potentially set up dampened risk portfolios of commodity investments, which are very nearly uncorrelated with each other. But we have also found that seemingly unrelated commodity markets can become temporarily, highly correlated. This becomes problematic if a commodity manager is designing a portfolio so that only a certain amount of risk is allocated per strategy. The portfolio manager may be inadvertently doubling up on risk if two strategies become unexpectedly correlated.

The antidote for this problem is two-fold. One is to understand what key factors drive a strategy's performance, and the other is to use short-term, recent data in calculating correlations. If two trades have common drivers, then it can be assumed that their respective performances will be similar. Recent data can frequently capture the time-varying nature of correlations that long-term data average out.

In addition to understanding the statistical characteristics of an investment, risk-management policies frequently flow from product design decisions. Futures products are typically marketed as equity investment diversifiers. Therefore, one job of risk management is to attempt to ensure that a futures investment will not be correlated to the equity market during periods of dramatic equity losses.

If a portfolio shows sensitivity to certain extreme events when the stock market has declined, this does not necessarily mean that the portfolio should be sized differently or constructed differently. It may mean that a macro portfolio hedge would be in order, such as purchasing out-of-the-money fixed-income call options when the portfolio has a sensitivity to a liquidity shock or purchasing out-of-the-money gasoline call options when the portfolio has a sensitivity to a sharp shock to business confidence.

On a per-strategy basis, it is useful to examine each strategy's:

- Value-at-Risk based on recent volatilities and correlations;
- Worst-case loss during normal times;
- Worst-case loss during well-defined eventful periods;
- Incremental contribution to Portfolio Value-at-Risk; and
- Incremental contribution to Worst-Case Portfolio Event Risk.

On a portfolio-wide basis, it is useful to examine the portfolio's:

continued on page 8

Risk Management Lessons

continued from page 7

- Value-at-Risk based on recent volatilities and correlations;
- Worst-case loss during normal times; and
- Worst-case loss during well-defined eventful periods.

Each measure should be compared to some limit, which has been determined based on the design of the futures product. For example, if clients expect the program to lose no more than say 7% from peak-to-trough, then the three portfolio measures should be constrained to not exceed 7%. If the product should not perform too poorly during financial shocks, then the worst-case loss during well-defined eventful periods should be constrained to a relatively small number. If that worst-case loss exceeds the limit, then one can devise macro portfolio hedges accordingly.

One illustrative example concerns two financial futures spread trades. This example portfolio consists of a long Russell 2000 vs. short S&P 500 futures trade and a long Municipal Bond vs. short Long Bond futures trade. These trades are normally unrelated. But during a scenario test of the portfolio's sensitivity to event risk, we note that the combination of the two trades results in an exposure to a liquidity shock, as shown in the figure below.

The short legs of each spread are the more liquid of the pair. This means that both of these trades are at risk for a flight-to-quality event, as happened in the fall of 1998. The scenario tests confirm that the fall of 1998 scenario is the worst case scenario.

As mentioned above, one risk management response to a concentrated risk to a liquidity shock is to purchase out-of-the-money fixed-income calls, which would be expected to do well during such a shock.

We conclude by noting that our view is that there are a number of derivatives strategies, which earn returns due to assuming risk positions in a risk-adverse financial world. The returns are not necessarily due to inefficiencies in the marketplace.

There is a very important active component to an investment program that earns a return due to bearing risk. It is the investment program's risk management methodology and policy. An investment manager must decide how much to leverage the strategy and whether to give up any returns by hedging out some of the strategy's extreme risks. That investment manager must also continually monitor the risk exposures in his or her portfolio and make sure that those exposures adhere to pre-defined limits.

How one designs and carries out a risk management policy is key to an investment program's viability, especially in leveraged futures trading.

Evaluation of Portfolio Event Risk

Event	Maximum Loss
October 1987 stock market crash	-4.11%
Gulf War in 1990	-4.12%
Fall 1998 bond market debacle	***-6.42%***
Aftermath of 9/11/01 attacks	-3.95%
Worst-Case Event	**Maximum Loss**
Fall 1998 bond market debacle	***-6.42%***
Value-at-Risk based on recent volatility and correlations	3.67%

Source: Till, Hilary and Joseph Eagleeye, "Traditional Investment Versus Absolute Return Programmes," Quantitative Finance, June 2003, Table 5.

Hilary Till co-founded Chicago-based Premia Capital Management, of which she is a portfolio manager, with Joseph Eagleeye. Premia Capital specializes in detecting pockets of predictability using statistical techniques. Till is also a principal of Premia Risk Consultancy, which advises investment firms on derivatives strategies and risk management policy. E-mail: ***till@premiacap.com*** ***http://www.premiacap.com***

Are Hedge Funds Secure?

By Bob Pollock, CEO, & Sean Chumura, CTO, CoSolutions Systems, Inc.

Making money in the markets is hard enough without having to worry about security. But more and more hedge fund managers and institutional investors are questioning whether or not hedge funds are secure against such problems as hacking, espionage, and "viruses." In a nutshell, do you know if your hedge fund is being hacked? Some of the following questions related to security may be important to ask yourself. How do you know if your hedge fund is trading off real information or whether it is trading based on corrupted data? What will happen if data is wiped out or changed? Is a competitor trying to hurt a hedge fund through hacking? Are the communications to and from the hedge fund secure? Are hackers targeting your data for fun and/or profit? Are you living up to your regulatory burden? Are your auditors going to be happy and satisfied as they go through your records and evaluate the security measures you took to protect your data? And so on…

Now that hedge funds live in a digital world, they can easily be attacked, hacked and erased from the face of the earth without leaving any trace.

The advent of digital everything is a huge boon to hedge fund productivity. The ability to get information – now available on just about every instrument in the world – and trade it online is revolutionizing trading. Small hedge funds now have the informational power that only big banks had ten years ago. It would have been unthinkable to manage a big book of derivatives on a desktop machine ten years ago. Now, the computation power of desktops dwarfs the power of mainframes from the 1980s. But all of this means that hedge funds are now at the mercy of all these electrons. Now that hedge funds live in a digital world, they can easily be attacked, hacked and erased from the face of the earth without leaving any trace.

The title of this article asks: "Are hedge funds secure?" The short answer is "No!" Electronic information and data are easily acquired, hacked and mutated in the current electronic age. Hedge funds must face many challenges in digital security. They have a fiduciary duty for the funds under their care. They are coming under increasing regulatory scrutiny.

There are many insecure points in the average hedge fund's setup. The most common one is the desktop that is now *de rigeur* for a trader. This desktop is usually connected to the Internet…. Bingo, you're dead. There is hardly a desktop on Earth that has not been subject to an attack by a virus or worm. The Chernoble virus aimed to wipe out your hard drive. The newer worms embed themselves into the system and remain dormant until they are triggered to execute their hidden commands. The latest MyDoom worm triggers denial of service attacks against other sites. What is your liability for participating in such an attack?

But wait, is that what that virus is actually doing? Other viruses are key loggers, which harvest sensitive information, such as passwords. What is the liability of a hedge fund if a virus harvests passwords and money is stolen or bogus trades executed? It is only a matter of time until a hedge fund is targeted for serious hacking to either destroy the fund or to siphon off money from the fund. Why shouldn't a hacker enter a bogus trade and front run it? Why shouldn't a hacker send in a bogus wire transfer? Why shouldn't a hacker switch all the longs to shorts?

Right now, the two main lines of defense are $89 anti-virus programs and hoping that the prime broker/custodian has the correct data. We think that $89 anti-virus programs are a fine way to rid your PC from yesterday's virus but essentially worthless to protect against today's viruses. Yes, it is likely that your prime broker can fix any suspect or bad data you have at the end of the day, but that still leaves you vulnerable during the day. And that is assuming that you and the broker will identify your discrepancies and resolve them instantaneously. The reality is that sometimes these discrepancies can take several days to resolve.

We recently worked with a client that suffered a hack attack that wiped out just about every file on the server. It took a

continued on page 11

NASD Issues Interpretive Guidance On Hedge Fund Sales Materials

By Michael P. Malloy, Partner, Drinker Biddle & Reath LLP

In October 2003, the NASD staff published interpretative guidance to members for hedge fund and fund of fund sales (the October Letter). The October Letter addressed: reasonable-basis suitability; placement agent recommendations; risk disclosure; and related performance. The NASD staff also issued clarifying guidance in December 2003 relating to related performance information for hedge funds and fund of funds (the December Letter). This article summarizes those letters.

Reasonable-Basis Suitability

NASD Notice to Members 03-07 (NTM 03-07) discusses sales practices obligations, including reasonable-basis suitability, for hedge fund sales. NTM 03-07 directs members to conduct due diligence for a recommended hedge fund by: (i) investigating the background of the hedge fund manager; (ii) reviewing the offering memorandum; (iii) reviewing the subscription agreements; (iv) examining references; and (v) examining the relative performance of the fund.

The October Letter states that NTM 03-07 was not intended to suggest, in the case of a fund of hedge funds, that the same due diligence must necessarily be performed on underlying funds. The October Letter explains that the analysis of whether due diligence is required on an underlying fund is fact-specific. The NASD staff indicated in the letter that inspection of an underlying fund is required only when inspection of the parent fund suggests that an inspection of the underlying fund is warranted. The NASD staff also noted that a member's due diligence of such a fund is complete when it establishes a sufficient basis to evaluate the merits and risks of the investment.

Placement Agent Recommendations

The October Letter clarifies that an NASD member may be considered to have recommended a transaction when it brings a specific fund to the attention of a customer through any means, including direct telephone communication, use of the mails, or electronic transmission, even if a member is only acting as a placement agent.

Risk Disclosure

In April 2003, the NASD announced that it had fined Altegris Investments, Inc. (Altegris) for failing to adequately disclose a list of nine hedge fund risks in its sales literature, although some or all of these risks may have been described in the hedge fund's offering documents. In a press release, the NASD stated that Altegris' marketing pieces "failed to include important disclosures regarding specific risks of investing in hedge funds and made unbalanced presentations about the particular hedge funds that failed to provide investors with a sound basis for evaluating whether to invest in these hedge fund products."

The October Letter explains that lists of risk factors do not have to be included in each piece of hedge fund sales literature used by a member. However, each piece of sales material has to: (i) be based on principles of fair dealing and good faith; (ii) provide a sound basis for evaluating the facts in regard to any particular security disclosed; and (iii) not omit material facts or qualifications that would cause the communication to be misleading. The October Letter also clarifies that each piece of material must include disclosures that are necessary to ensure that it is fair and balanced.

Related Performance

The NASD has historically prohibited members from using related performance information in marketing materials for hedge funds. Related performance information includes the performance of other investment companies, hedge funds, portfolios, accounts or composites managed by the hedge fund adviser. Related performance information does not, however, include the performance of a master fund of which a hedge fund is a feeder fund to the extent it reflects the performance of the same portfolio of securities in which the hedge fund's assets are invested.

Under the October and December Letters, no NASD member may publish or distribute sales material for a hedge fund that includes performance information, unless the fund relies on the Section 3(c)(7) exemption under the Investment Company Act of 1940 ("3(c)(7) Fund"). The NASD staff noted that 3(c)(7) Funds do not present the same investor protection concerns as other hedge funds or mutual funds because 3(c)(7) Funds are

continued on page 11

NASD Issues Interpretive Guidance

continued from page 10

limited to "qualified purchasers" under the Investment Company Act of 1940. The NASD staff has also informally stated that the NASD related performance prohibition does not apply to related performance information contained in a fund's private placement memorandum, even if it is not a Section 3(c)(7) Fund.

In the December Letter, the NASD staff also reminds members that any hedge fund sales material must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts about the fund. The December Letter also notes that a member may not make any false, exaggerated, unwarranted or misleading claim in a communication with the public, or any communications with the public that predict or project performance, imply that past performance will recur, or make any unwarranted claim, opinion or forecast.

*Michael P. Malloy (**michael.malloy@dbr.com**) is the head of and a partner in the Investment Management Group at Drinker Biddle & Reath LLP.*

*Joshua B. Deringer (**joshua.deringer@dbr.com**) and Michael E. Dresnin (**michael.dresnin@dbr.com**), associates in the Investment Management Group, assisted in the preparation of this article. Established in 1849, Drinker Biddle's more than 450 lawyers serve clients throughout the United States and abroad. Drinker Biddle's Investment Management Group, one of the premier practices in the country, counsels a broad range of national and multi-national financial institutions, traditional and alternative investments funds, and individuals.* ***www.drinkerbiddle.com***

Are Hedge Funds Secure?

continued from page 9

day to restore the server back to what was thought to be the condition before the attack. However, 30 days later, the virus cropped up again and once again wiped out the disk. It took another iteration of this occurence before we were brought in to wipe out this virulent strain once and for all.

The Sarbanes-Oxley Act is creating havoc in large public companies because it effectively requires them to certify the veracity of their data. What hedge fund today would be willing to make the same certification? The key to successful hacking is to siphon money and information without the victim knowing about it. Furthermore, organized crime is not interested in the notoriety that some hackers crave, but they do want the money that smart hacking can bring. Banks suffer huge losses each year to hackers but keep it quiet to discourage the practice. We believe that hedge funds will become more vulnerable as they control more and more money.

Remember, there are professional tools and services that create a near immunity to hacking, (i.e., CEO Protection/Audit System). These cost more than the off-the-shelf anti-virus programs but their cost is nominal when you consider the consequences of not having the protection you need. Such services are certainly cheaper than having to answer the questions about the veracity of your data to your auditor, client or regulator. The investment is worthwhile if it spares you from the embarrassment of justifying to all three, as well as to your investors, how and why you lost money because of viruses and hackers.

Bob Pollock is CEO of CoSolutions, a New York City based Network Security OEM & Consultancy, which on March 1, 2004, announced & released its "CEO Protection/Audit System" along with other complementary new security product solutions. Prior to CoSolutions, Bob had an extensive background as a security & business consultant and as president & senior executive of several other IT technology firms over his forty-year career. Sean Chumura is CTO & inventor/developer of CoSolution's Systems & products. He brings an extensive security background including the forensic sciences. His clients include Bloomberg, Disney, the FBI, CERT, the DOD, and many others. CoSolutions can be reached at: 917-497-5523 or at: ***CoSolutions@safe-mail.net***

Valuation Challenges for Hedge Funds

continued from page 2

prime brokers and other industry experts identified the challenges presented by valuing security or derivative positions that have no ready market price. A strict application of the rules applicable to the mutual fund industry or private equity industry, the moderator stated, while being important references, should not automatically be the starting point for a discussion about best practices for hedge funds. The panel members discussed situations in which a market price may be unsuitable for use or not available at all, as is the case with certain over-the-counter derivative instruments and structured or distressed securities. Prices on these types of instruments are not available from data vendors because they are either "one of a kind" or not actively traded; therefore the fair value of the instrument must be determined in the absence of a market price. The panelists noted that it may also be appropriate to determine the fair value of an instrument rather than use the last market quotation when a significant event occurs between the time of the quotation and the time of valuation. When a security or derivative instrument falls into the category of illiquid or complex, the panelists stressed the need to categorize the instrument and consider alternative valuation methods in properly valuing such instrument. The panelists recommended that the valuation process for these instruments be thoroughly documented.

The panelists discussed at great length the extent to which hedge fund managers and traders should be involved in the valuation process.

As part of the panel, Charles Smithson of Rutter Associates LLC described preliminary results of a valuation survey that his firm recently conducted. Based on a limited sampling of hedge fund managers, credit portfolios appeared to be most prone to valuation challenges, with only 30% of respondents saying this category posed no valuation difficulty. Fixed income and equity portfolios were about equal in terms of the proportion of difficult-to-value assets, while foreign exchange posed the fewest valuation issues. The results indicated that more than one third of those surveyed mark hard-to-price securities in equity and fixed income portfolios according to their own models. An even larger percentage of respondents use model-generated marks for credit default swaps and other illiquid credit instruments.

The panelists expressed different views about whether or not hedge fund managers should be conservative when determining the fair value of complex instruments. One panelist noted that an overly conservative valuation could be unfair to redeeming investors, echoing a concern raised by the first panel. Hedge fund managers should seek valuation practices that are consistent and fair to both subscribing and redeeming investors. The use of third-party pricing services was also recommended, although the panelists cautioned that pricing services are not always reliable and prices obtained should be periodically reviewed.

There were differences of opinion as to whether or not pricing should be independent of trading. The panelists discussed at great length the extent to which hedge fund managers and traders should be involved in the valuation process. One panelist noted that portfolio managers and traders should review their valuation methods on a regular basis to identify any potential for errors. The panelists also discussed the role of administrators and prime brokers and whether prime broker prices were reliable as a source of information. The panelists agreed that brokerage prices are reliable if the broker actively trades the instrument and stressed the need to recognize the basis upon which the broker was pricing the instrument.

Session 3: Accounting Principles and Disclosure Obligations

Lauren Teigland-Hunt, Office of Lauren Teigland-Hunt; David Gross, Ernst & Young LLP; Paul Roth, Schulte Roth & Zabel; Robert Sullivan, PricewaterhouseCoopers

The panelists stated that although the securities laws do not require hedge funds to value their assets on a fair value basis, nearly all hedge funds are audited and must therefore

continued on page 13

Valuation Challenges for Hedge Funds

continued from page 12

value their assets in accordance with GAAP. Under GAAP, the same valuation principles apply to hedge funds as apply to registered investment companies, such as mutual funds.

The panelists discussed the ways in which auditors verify pricing of a fund's assets and how auditors might resolve differences in prices obtained for the same instrument. The panel also noted that a fund's offering documents typically provide hedge fund managers with the flexibility necessary to employ valuation methods that are appropriate to an instrument under the circumstances (*e.g.*, by using a proprietary model in situations where there is no market price available or by using a measure of fair value when the application of a market price would not produce a fair valuation for a given instrument). The panelists generally had a favorable view of the use of alternative valuation methods provided that hedge fund managers are able to justify the valuation method used to auditors and investors. The panelists addressed the differences between pricing based on bids obtained for valuation purposes and bids obtained for actual transactions and asserted that the latter are preferable if available. They also discussed how auditors confirm bids provided by third parties and their preference for discussing bids directly with dealers and banks, noting that these entities are not always willing to engage in direct discussions.

The panelists observed that many hedge fund managers that deal regularly with difficult-to-value instruments form valuation committees to address material valuation issues. Some panelists suggested that especially illiquid investments could be separated from other portfolio assets for valuation purposes by placing them in a "sidepocket." Use of a "sidepocket" must be properly authorized by the fund, and the procedures applicable to side pockets should be carefully documented.

The panelists agreed that hedge fund managers should establish policies for the manner and frequency of computing a fund's net asset value and that such policies should be appropriately disclosed in the offering documents. In particular, the panelists asserted, appropriate personnel at a hedge fund manager should develop and implement clear and consistent valuation procedures and ensure that the detailed procedures are consistent with the broader valuation policies disclosed to a fund's investors. In addition, hedge fund managers should ensure that they have the necessary checks and balances to ensure adherence to its valuation policies and procedures. The panel cautioned that the failure to have appropriate procedures can result in legal liability, noting a recent enforcement action that was brought by the SEC against the principal of an unregistered investment adviser for failure to supervise personnel who were overstating a hedge fund's performance.

---

*This summary was prepared by Timothy P. Selby and Manuela A. Cattaneo of Cadwalader, Wickersham & Taft LLP. Email: **timothy.selby@cwt.com** or **manuela.cattaneo@cwt.com** or visit **www.cwt.com.*** *This is a general summary and does not constitute legal, professional or accounting advice. If you have particular questions about the matters discussed in this summary please contact your professional adviser.*

June 14-16, 2004
The Waldorf-Astoria
New York

Plan to attend MFA's premier summer conference for the hedge fund and alternative investment industry. An educational and provocative program is being developed, featuring:

- Keynote Speaker: Don Putnam, Putnam Lovell
- Keynote Speaker: Afsaneh Beschloss, Carlyle Asset Management
- General sessions: ***Institutional Trends in the Use of Alternatives***, and ***The Strategists Perspectives***
- ***Star Search*** sponsored by Carr Futures
- ***Special Program for Emerging Fund Managers***
- and much more !

Exhibit Booth Space and Sponsorship Opportunities are Available!

For the most up-to-date conference program including exhibitor and sponsorship information, and to register online, please visit ***www.mfainfo.org/events/forum2004*** or contact MFA at 202.367.1140.

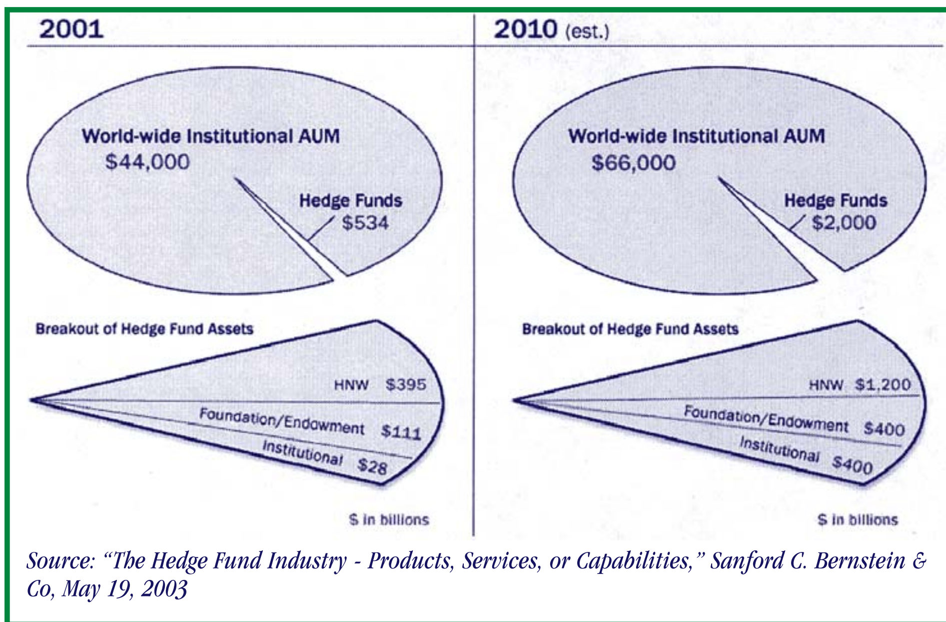
Absolute Return Money Management

continued from page 6

Absolute Return Money Management

Based on current estimates, there are 6,500 to 7,000 hedge funds operating globally managing approximately $700 to $750 billion in assets. In the next 8 years, hedge fund assets are predicted to exceed $2 trillion, as noted in "Staff Hedge Fund Report Fact Sheet," U.S. Securities and Exchange Commission, September 2003.

Although it still appears that the "absolute return money management investment" infrastructure is too small to become a significant alternative to traditional long only, non-hedged investment management, this is likely going to change dramatically over the next ten years. Not only will there be a continued proliferation of alternative management styles dominated by hedge funds, but many traditional managers will also adapt their investment mandates to include hedged or absolute return oriented funds.



Source: "The Hedge Fund Industry - Products, Services, or Capabilities," Sanford C. Bernstein & Co, May 19, 2003

In 1990, over 80% of the money in hedge funds came from high net worth individuals. Today the dominant players in hedge fund investing, with over 55% of the assets, are institutional investors such as endowments, foundations, and plan sponsors including Taft-Hartley funds. Yet the dollars invested still represent a fraction of the assets that will likely be invested in the asset class. As the market has shifted increasingly towards the institutional investor, the hedge fund market has adapted to meet the requirements of a far more demanding investor — it is rapidly morphing into an institutional friendly architecture. Increasingly, managers will become Registered Investment Advisers. They will provide levels of transparency, client service and support that institutional investors will demand, and they will provide the necessary risk, style drift and operational controls that will allow the institutional investor fiduciary comfort.

As mentioned, various sources estimate that hedge fund assets have grown to over $700 to $750 billion dollars under management as of year-end 2003, with most of this growth occurring over the past 5 years. In 1990, there were estimated to be only 200 or so hedge funds in the entire world managing approximately $20 billion. It is likely that hedge fund assets will grow to in excess of $2 to $2.5 trillion over the next 10 years, if not considerably greater, as fiduciary demands result in increasing pressure for pension funds to allocate 5-10% of their financial assets to absolute return managers. On a global scale, 5-10% of financial assets would actually result in allocated assets of $3 to $6 trillion.

The accelerating money management paradigm shift towards hedge fund investing by institutional investors, which still is being underestimated, is based on a number of key factors: the obvious failure of the prevailing long-only investment style during the recent bear market; a deepening pool of available managers and fund styles to attract and manage the capital seeking to invest; and, very importantly, better and more reliable performance data along with the academic research that drew upon this data to create a clear and compelling case for significant asset allocations to hedge funds.

It is very likely that by the end of this decade, plan sponsors and benefit recipients will consider it a fiduciary requirement

continued on page 21

continued from page 4

MFA Submits Comments to NASD to Oppose Efforts to Rescind Policy on Trail Commissions for Commodity Brokers

Since last fall, MFA has been engaged with the staff at the NASD expressing our concerns with their proposal to rescind the policy of permitting trail commissions paid to commodity broker-dealers. In February 2003, the NASD issued a Notice to Members with respect to Direct Participation Programs (DPPs). The NASD requested comment on the rescission of a longstanding NASD interpretative policy permitting trail commissions charged by commodity brokers. On March 12, MFA submitted its comment letter in response.

The NASD requested comment on whether the "higher trail commissions in commodity DPPs justified by the quality and level of service provided to accounts that hold these investments." In our March 12 letter, MFA vigorously defended the policy allowing trail commissions that has been in place for over two decades.

Our comment letter to the NASD provided important background information on the regulation of the commodity pool industry and trail commissions more specifically. We maintained that publicly offered commodity pools are generally viewed as offering the "safest and least expensive mechanism for retail investors to engage in futures trading for investment and/or portfolio diversification purposes." We further justify why trail commissions must be paid to associated persons, who must pass the Series 3 or Series 31 examinations. The services provided in return for the trails require substantial knowledge of both the product and the commodity markets. Without these associated persons, a pool's CPO would have to incur additional expenses to develop an alternative mechanism for providing such services to pool investors. If the NASD's rescinds its policy, we believe that "retail investors will be denied access to the only affordable futures-based product currently available in a limited liability structure." MFA believes that the NASD's policy on trail commissions should be codified through a rule amendment.

This is an area of importance to many Members in the managed futures area, particularly issuers of public commodity funds and their brokers. MFA shall continue to advocate our position before the NASD staff in the weeks ahead. We shall keep Members informed of our progress in this area.

MFA Continues to Expand Its Educational Initiatives for the Alternative Investment Industry

MFA has a busy schedule of events this winter and spring to further its educational initiatives for the alternative investment industry. MFA president, John Gaine, participated in the ABA conference on "Futures and Derivatives Regulation" on February 13 where he served as a panelist on the topic of hedge fund regulation. He will also be a speaker at the Futures Industry Association conference on March 16, Boca Raton, Florida. He will also deliver the opening remarks at Terrapinn's "Hedge Funds World USA 2004" conference in New York City on March 29. MFA vice president and senior legal counsel, Stephanie Miranda Pries, will also provide an overview of hedge fund regulatory issues at a Mid-Atlantic Hedge Fund Association event in Princeton, New Jersey on March 25. She shall also be a panelist at Institutional Investor's, "Hedge Fund Regulation and Compliance" conference where she shall speak on current issues facing the hedge fund industry on March 30. Next month, Ms. Pries is will be a panelist on hedge fund regulation at the Practising Law Institute's 2004 Investment Management conference on April 22 in New York. MFA staff will be speaking at a number of other industry events in Spring 2004.

In late January, MFA also hosted a seminar, "Valuation Challenges for Hedge Funds" in New York. Almost 200 attendees participated in this event. (Please see the article on page one of this issue of the *MFA Reporter* summarizing the discussion at this seminar.) Other MFA-sponsored events scheduled for later this year shall be on topics of interest to our Members.

MFA Continues to Monitor the Following Issues:

- Impact of SEC's Final Custody Rules for Registered Investment Advisers
- "Related Performance" in Hedge Fund Marketing Issues at NASD
- Soft Dollar Issues at SEC and NASD
- Pending Anti-Money Laundering Rules at Treasury

A New Way to Save for Health Care

By Margaret Sheridan and Scott S. Anderson, CPA, Arthur F. Bell, Jr. & Associates, L.L.C.

A new opportunity for savings has been created under the Medicare Prescription Drug, Improvement and Modernization Act, which President Bush signed into law in December 2003. Health Savings Accounts (HSA) are tax-free savings plans used to offset out-of-pocket medical expenses. They are similar to Individual Retirement Accounts (IRA) in that the amounts contributed are tax-exempt and the investment is allowed to grow tax-free. The distributions for medical expenses are also tax exempt. The parameters of HSAs follow.

Eligibility

Generally, an eligible taxpayer is one who is covered under a high deductible health plan, and is not covered under any other kind of health plan. A high deductible plan for an individual has an annual deductible of at least $1,000 (indexed for inflation) and an out-of-pocket expense limit of no more than $5,000. For family coverage, these amounts are $2,000 and $10,000, respectively. Individuals over the age of 65 are not eligible.

Distributions from a Health Savings Account for the account beneficiary's qualified medical expenses are excludable from gross income.

An individual would not fail to be eligible if, in addition to a high deductible plan, he has coverage for accidents, disability, dental insurance, vision care, or long term care. Additionally, an individual would not fail to qualify if he has coverage provided by "permitted insurance." Permitted insurance is insurance under which substantially all of the provided coverage relates to workers' compensation, tort liabilities, liabilities relating to ownership or use of property (such as automobile insurance), insurance for a specified disease or illness, or insurance that pays a fixed amount per day of hospitalization.

Contributions and Tax Consequences

The maximum annual contribution that may be made to an HSA for tax years beginning after December 31, 2003, is the lessor of the annual deductible under the individual's high deductible health plan, or $2,600 for an individual with self-only coverage and $5,150 for an individual with family coverage. These amounts are indexed for inflation. The deposits, buildup, and withdrawals are tax-free. Taxpayers may carry over the balance year after year. Individuals 55 years old or older (but not over 65) may contribute an additional $500 in 2004, $600 in 2005, $700 in 2006, $800 in 2007, $900 in 2008, and $1,000 in 2009 and thereafter. To take advantage of the tax benefits, the contribution to the account may be made by April 15th of the following year, similar to an IRA contribution.

The cash contributions made to an HSA by or on behalf of an eligible individual are deductible from that individual's income. This is an "above-the-line" deduction from gross income. Employers might consider changing over to a medical plan with a high deductible. Employers would pay no employment taxes on contributions made to such a plan. A high-deductible plan may be more beneficial (to both employer and employees) than its alternatives now that HSAs are available.

Individuals who have an Archer Medical Savings Account (MSA) may rollover the amount in the MSA tax-free into an HSA. The rollover amount is not included in the calculation of the maximum allowable contribution for the year. No new Archer MSA plans may be established after December 31, 2003.

Distributions from an HSA for the account beneficiary's qualified medical expenses are excludable from gross income. Distributions from an HSA that are not used for qualified medical expense are includable in gross income and are also subject to a 10 percent tax penalty (similar to IRAs) unless made after the beneficiary's death, disability, or attainment of the age of Medicare eligibility. When a taxpayer reaches age 65, distributions are still tax-free provided that they are used

continued on page 19

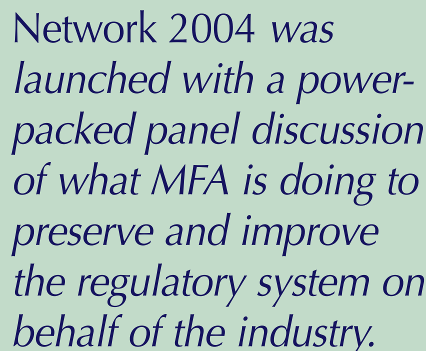
PR News and Reviews

Puttin' on the Ritz at Network 2004

By Meg Bode, MFA PR Consultant

A record breaking 500 delegates helped MFA christen *Network 2004* at its newest venue, The Ritz-Carlton, Key Biscayne, February 8-10. The conference was plush with prestige thanks to our premiere keynote speakers, top shelf general session participants, best of class workshop presenters, and luxurious surroundings.

The pre-conference hospitality tent on the 18th green at the Senior PGA Golf Tournament was a sight to behold. The all-day event on Sunday provided a splendid tee-off to networking, as delegates enjoyed the privilege of watching golf legends finish the final round of their tourney among throngs of hushed, happy fans.



That night, at the conference Welcome Reception, a capacity crowd nearly overflowed the ballroom and firmly established an upbeat tempo that lasted until well after the finale reception two days later. Throughout the conference, MFA sponsors and exhibitors were rewarded with bustling activity at the booths and strong attendance at the sessions, even as warm Miami sun competed for attention outdoors.

First thing Monday morning, Adam Cooper, MFA Chairman, extended a warm welcome and encouraged delegates to become active members of the association. He stressed the importance of unity under the association umbrella; for professionals to share business concerns, build strength in numbers, and speak with a unified voice with regulators in Washington, with the media and with investors.

With regulatory affairs top of mind, *Network 2004* was launched with a power-packed panel discussion of what MFA is doing to preserve and improve the regulatory system on behalf of the industry. MFA President Jack Gaine shared a litany of current initiatives with the SEC, CFTC, NASD, IRS, Treasury, President's Working Group and Financial Services Authority. It is obvious that MFA's mission to educate government and demystify hedge funds is in full swing. George Crapple of The Millburn Corporation, Joel Press of Ernst & Young, Paul Roth of Schulte Roth and Zabel, and Chairman Cooper of Citadel Investment Group joined Mr. Gaine's panel on the "Hedge Fund Regulatory Update."

Collectively, this intelligentsia cautioned us about "regulatory creep" and encouraged the continuance of holding mandatory registration in abeyance. Mr. Roth offered a rhetorical, "We are all regulated, why do we need to be registered?" And Mr. Crapple agreed by questioning the efficacy of regulatory audits: how could regulators understand position detail and spot a problem, even if one existed? He cautioned that added regulation might cause barriers to entry for our entrepreneurial industry. "There is a huge downside to regulatory creep," Mr. Crapple warned. "The vibrancy of the industry could be lost and that would be a real shame." Mr. Press offered an interesting concern saying that fraud is the biggest risk in the industry, and he worries that individuals would appear legitimate just because they may be registered. Mr. Press stressed the value of sound practices, and espoused the benefits of having written procedures in place for various business functions. He said procedure and compliance are the hot issues and that having in-house counsel and compliance procedures (third party is fine) in place are vital. "If no procedures are in place," Mr. Roth added, "the SEC can get you for failure to supervise." It is imperative to get MFA out in front of regulatory creep by establishing industry standards and self-policing, added Chairman Cooper. Due diligence is key. All in all, the panelists agreed that we are in the midst of a critical sea change, and it is incumbent on each participant to establish sound business practices for their firms and strive for excellence in every aspect.

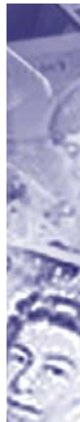
The "Transparency Debate," moderated by Carol Kaufman of SunGard, promised opposing viewpoints and a heated

continued on page 18

continued from page 17

exchange; however, the panelists wound up less divergent than expected. The chasm of disagreement was fairly slight – mostly about how much detail to provide. Standardization in the making? Not quite. And, in fact, maybe never, according to John Kelly, CEO of Man Investment Products. Mr. Kelly said each of the three business units he manages operates differently, but that in all cases it is imperative to tell investors what they can expect. The general consensus was that one size does not fit all. Communication is key, and managing expectations is imperative.

Meanwhile, Brad Cole of Cole Partners presented a powerful, information-packed panel illustrating the "Quantitative Approach to Asset Allocation." The level of detail provided by Norman Mains of Morgan Stanley was illuminating, even for industry veterans. This panel was very focused and highly educational, including vital insights from Michael Howell of CrossBorder Capital.



This experienced group discussed pricing and valuation and agreed that the industry must develop valuation standards and espouse sound practices.

Ramon Koss provided an impressive perspective as the first keynote luncheon speaker. Mr. Koss, head of Alternative Investments and Mutual Funds, Credit Suisse Private Banking, satisfied our intellectual palate with his well-documented recipe for success in alternatives. Why are alternatives so sought after in today's marketplace? Many familiar factors were on his list. For one, long only is now too risky, and pensions MUST do something to improve returns and decrease risk. Alternatives, he stressed, should not be regarded as more dangerous than long only. Mr. Koss observed that even in a great stock year, alternatives took in increased assets. Mr. Koss pointed to the banks as evidence that alternatives are here to stay. Banks, he noted, see alternatives as a source of fee income. The only risk involved is poor perception based on an overall lack of knowledge and misunderstanding. Once again, education is the essential ingredient as due diligence ultimately rests with the investor. What does one of the world's most significant hedge fund allocators predict for the future of the industry? Although 40% of new assets raised are through funds of funds, Mr. Koss believes that index products will become increasingly popular. We'll check back with him next year.

This year's Best Practices workshops covered some new territory with presentations on "Branding: How to Create Competitive Advantage and Increase Assets," "Legal & Business Issues Facing CPO/CTAs after Recent CFTC Regulatory Changes," "Benefits of Offering Multiple Trading Systems," "How to Present Yourself to the Press," and "Mitigating Operational Risk."

The inimitable David Darst of Morgan Stanley opened day three with rational exuberance. Mr. Darst shared his brilliant, eye-popping and witty insights, based on his popular book, *The Art of Asset Allocation*. A veritable stat-man, Mr. Darst recited pivotal events, dates and economic factoids that, while listening to him, resonated deeply and made perfect sense. Alternatives, it turns out, are a vital component of an asset allocation model. Look no further than the Harvard Management Company Policy Portfolio for proof. The allocation to commodities is nearly as large as their domestic equity investments. If you want to know more, and who wouldn't, you can buy his book! And, if you didn't make it to his speech, don't miss your next opportunity to see him. He is a five-star one-man show.

Yet another eye-opener was the Risk Management panel led by Kevin Mirabile of Barclays Capital. An astute moderator, Mr. Mirabile facilitated a thought-provoking session with a remarkable cast including Ken Grant of Exis Capital Management, Amy Hirsch of Paradigm Consulting Services, and Sarah Payne of Credit Suisse First Boston. Mr. Grant tackled early-stage risk, based on the question, how do you attract and retain capital vs. run a business? It is hard for a manager to build an institution, he cautioned, because there are many moving parts to building infrastructure that need to be balanced against how much money to raise, how to structure fees and issues of scalability. Amy Hirsch went to bat on business risk and provided some pithy commentary on how her firm assesses operational risk, portfolio risk, market risk and instrument risk. All managers need to be looked at differently, she stressed, as they are all completely different. Sarah Payne was challenged with Mr. Mirabile's

continued on page 19

PR News and Reviews, *cont'd.*

continued from page 18

query about leverage: Does leverage equal risk? There is no simple answer for measuring leverage according to Ms. Payne, who explained in detail just how complicated the issues of leverage can be, depending on the asset class. This experienced group discussed pricing and valuation with enthusiasm and agreed that the industry must develop valuation standards and espouse sound practices.

James Hedges, founder, president and CIO of LJH Global Investment, provided a fresh perspective on the importance of thought leadership in his keynote luncheon address, entitled, "Growing your Business behind the Numbers." Mr. Hedges is dedicated to educating family offices and institutional investors about alternatives, and spoke passionately about his mission to demystify hedge funds. Praising MFA, he said a unified voice is critical to the further growth and maturation of the industry. As a strong advocate of business excellence, Mr. Hedges shared some concerns and highlighted a fairly extensive list of potential risks for the industry including issues of transparency, liquidity, size vs. performance, product innovation, soft dollars, prime brokerage and structured products. His prediction for the future? The winners will be multi-strategy hedge funds because they will appeal to large institutions.

Delegates moved outdoors on Tuesday afternoon for the Champagne Roundtables. "Optimizing Your Human Empire Portfolio," all about intellectual capital, was very enlightening, as was "Gathering & Retaining Assets in Challenging Times." For the final event of *Network*, delegates gathered near the beach for a finale reception. Sated with new information and new and strengthened relationships, we wrapped up *Network 2004* as the moon replaced the sun and its reflection danced across the ocean.

Many facets of sound business practices were explored in a short time at MFA's 10th Annual *Network* conference. The valuable commingling of newcomers and veterans provided a unique tapestry that, once again, demonstrated the importance of an industry association. MFA thanks all the sponsors, presenters and delegates for another successful program. Our next conference, *Forum 2004*, promises another opportunity to join MFA as we meet the challenges of shaping our future. Join us in New York, June 14-16 at The Waldorf-Astoria. Sponsorships and booth space are still available. See you there!

MFA on Accounting, *cont'd.*

continued from page 16

for medical expenses. Distributions, after the age of 65, for non-medical purposes will be taxed as ordinary income, but the penalty will not apply.

Qualified medical expenses for an HSA are generally those that may be deducted as an itemized medical expense deduction, which includes expenses incurred to diagnose, cure, treat or prevent a disease. It also includes the premiums for qualified long-term care insurance contracts.

Similar to IRAs, HSAs must have a trustee or custodian that administers the plan, such as a broker, bank, or insurance company. Several insurance companies have already indicated that they intend to offer the accounts.

If an account owner dies and has designated his or her spouse as the beneficiary, an HSA continues and is treated as the surviving spouse's account. If an HSA is passed to someone other than the surviving spouse, then the HSA ceases to be an HSA and the amount equal to the fair market value of the assets in the account will be taxable.

Employer Concerns

Rules similar to Archer MSA contributions apply to employer contributions to HSAs. No amount is included in the gross income of any employee merely because the employee may choose between the contributions made to an HSA or to another health plan of the employer. Any employer contribution to an HSA is allowed as a deduction only for the tax year in which it is paid.

If an employer makes contributions, he will be penalized if he fails to make comparable HSA contributions on behalf of all employees with comparable coverage during the same period. Generally, contributions are comparable if they are of the same amount or the same percentage of the deductible under the plan.

Summary

Health Savings Accounts mitigate the impact of high-deductible health insurance and allow tax-free savings. If you decide to explore such a savings strategy, you should consult with your tax advisor to determine whether this is an appropriate tool for you or your company.

Arthur F. Bell, Jr. & Associates, L.L.C. is a public accounting firm providing a full range of audit, tax and consulting services to the managed funds industry. For more information, please visit: ***www.afb-a.com***

MFA Member News

Weston Capital Management hired **Pascal Roduit** to serve as senior portfolio manager. Mr. Roduit was previously with Atilma Capital Management LLC where he served as a managing partner. **Samir Das** also joins Weston's team as a junior analyst focusing on quantitative analysis. Mr. Das' primary responsibilities will be IT development and the maintenance of Weston's hedge fund manager database.

Bank of Bermuda's Global Fund Services division appointed Paul Ellis deputy head of global fund services in their Dublin office. Mr. Ellis joins from SEI Investments where he was head of fund accounting and administration. **Robin Fuller** was appointed the bank's head of global fund services from a previous position as managing director of Guernsey-based Rothschild Asset Management CI.

Jess Gaspar joined New York-based **Cornerstone Trading Co. Inc.** as director of research. Mr. Gaspar's background includes the World Bank, McKinsey, and the University of Chicago.

John Ehlers joined Charlotte-based **First Southeastern Capital Management** as director or research. Mr. Ehlers was previously president of MESA Software.

Sri Viswanath joined **Welton Investment Corporation** as a portfolio manager where he will be responsible for co-managing existing trading strategies as well as participating in new product research and development. Mr. Viswanath was previously with Niederhoffer Investments.

Strategic Financial Solutions, LLC (SFS) appointed three new sales representatives. **Eric Jacobson** joined the SFS European sales team in London. Mr. Jacobson was previously with Market Axess Europe. **Jason Rhodes** joined the New York based sales team from Canaccord Capital, where he was an investment advisor. **Patrick Johnson** joined the SFS Asia-Pacific expansion efforts. Mr. Johnson has more than a decade of sales and client service experience, as well as a wealth of technology knowledge.

Steven Felsenthal joined **The Millburn Corporation** as the first general counsel at the New York-based firm, where he will be responsible for a wide array of legal issues, including structuring products, working with outside counsel, contracts and compliance. Mr. Felsenthal previously worked with hedge funds at Schulte, Roth & Zabel.

Morgan Stanley appointed **Jack Inglis** head of business origination in Europe in an effort to develop the firm's convertible prime brokerage. Mr. Inglis assumes the new role from his previous position as head of international convertible bond sales and trading in London.

Sal Albanese joined **Mesirow Financial** as senior vice president of the firm's institutional market management group from INVESCO.

James Curley joined **Hotspot FXi** as director. Mr. Curley's experience in futures, securities and managed futures firms is extensive, including executive positions at Cresvale International (US) LLC and Republic Bank New York Securities Corp.

Ron Hevey joined **Millennium Partners** as a senior portfolio manager and investment director from Toronto Dominion.

New York based **Ellington Management Group LLC** appointed **Thomas Larkin** chief operating officer and **Paul Asara** chief financial officer.

Sabre Fund Management appointed **Dan Jelicic** and **Patrick Dugue** to manage the launch of their directional equity strategy Sabre Long/Short style fund.

The members of the **Kansas City Board of Trade** elected new directors to serve on its board. **Scott P. Smith**, vice president and manager of Kansas City operations for ADM Investors Services, Inc, was elected chairman for 2004. **Greg O'Brien** was elected to serve as first vice-chairman and **Daniel Gibson**, president of Wolcott & Lincoln Futures, LLC, will serve as second vice-chairman. The exchange also elected the following members to two-year terms on the board of directors: **Robert Kissick, Jr.**, Interstate Brands West Corp.; **Mark Owens**, an individual member; **Robert Rixey**, an individual member; **John Kearney**, an individual member; **James Sullivan**, Man Financial Inc.; and **Thomas Grabowsky**, an individual member.

Frontpoint Partners LLC appointed **Steve Eisman**, formerly a managing director and senior financial services analyst at Chilton Investment Co., to head a new investment team focusing on the financial services sector. Mr. Eisman's team will be made up of **Brad Berning**, formerly of Viking Global Investors, **Vincent Daniel**, formerly of Keefe, Bruyette & Woods, Inc., and **Porter Collins**, also of Chilton Investment.

Press Check

SEC Member Calls for Hedge Fund Restrictions, *Financial News*, 2-22-04

Gilded Cage: Hedge Funds vs. Washington, *The Street.com*, 2-20-04

Using Technology for Investor Protection, *HedgeWorld.com*, 2-20-04

Opposition Grows to SEC Hedge Fund Plan, *Financial Times' Front Page*, 2-19-04

The Business News with Howard Green, *ROBTV*, 2-19-04

Potential Hedge Fund Regulation, *Bloomberg TV*, 2-19-04

SEC Prepares to Tackle Hedge Funds, *South China Morning Post*, 2-18-04

Leverage Funds of Funds on the Rise, *Alternative Investment News*, 2-12-04

Greenspan Opposes SEC HF Registration Proposal, *HedgeFund.net*, 2-12-04

Fund Valuation: Art of Science?, *Securities Industry News*, 2-9-04

MFA Winter Confab Kicks Off, *Alternative Investment News*, 2-9-04

SEC Report on Hedge Funds, *Mondaq Business Briefing*, 2-5-04

Hedge Players Urge Valuation Common Sense, *FundFire*, 2-4-04

Regulators Turn Up Heat on Hedge Funds, *The New York Sun*, 2-4-04

Model-Driven Pricing Common for Illiquid Securities, *HedgeWorld News*, 2-3-04

Many Seek Changes to SEC's Proposed Short-Sale Rules, *Dow Jones News Service*, 2-2-04

Trade Groups Urge Haste upon the CFTC, *HedgeWorld News*, 1-28-04

Same Arguments, New Boss for Eurex, *HedgeWorld News*, 1-28-04

Morningstar Plans Hedge Fund Ratings, *HedgeFund.net*, 1-26-04

Industry Groups Urhe VFTC to Give Eurex US Speedy Approval, *Oster Dow Jones Select*, 1-26-04

SEC Grapples with Definition Issue, *Financial News*, 1-18-04

Mainstreaming of Hedge Funds May Gain Definition, *HedgeWorld News*, 1-15-03

Institutional Boom, Capacity, Regulation to be Felt in Industry, *Pensions & Investments*, 1-12-04

Absolute Return Money Management

continued from page 14

to have a statistically significant allocation to absolute return money managers, whether they are traditional hedge funds, separate accounts or 1940 Act funds.

The author, Tim Straus, is CEO and co-founder of StoneHedge Partners, Inc., an integrated hedge fund services organization. With offices in New York and Boston, StoneHedge Partners, Inc. serves hedge fund managers and institutional investors. The firm has designed a unique structure that provides independent risk oversight, operational support, transparency, client services and direct investor access to hedge funds.
For additional information: email ***timstraus@stonehedgepartners.com*** *or visit* ***www.stonehedgepartners.com.***