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The Convergence of Principle and Rule-Based Ethics Programs – an Emerging Global Trend?

Part 2 of 2

By Ronald E. Berenbeim & Jeffrey M. Kaplan

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In the first part of this article, which ran in the May issue of *Wall Street Lawyer*, the authors discussed the growing recognition that principles and rules are both essential elements in effective compliance programs. In this part of the article, the authors take a country-by-country look at what is happening in the ethics vs. compliance debate.

Promoting a Culture of Compliance in Australia

In 1998, six years before the U.S. Revised Sentencing Guidelines mandate to promote compliance within the organization, Australia's AS 3806 promulgated compliance standards established an ethical culture as a core element of an effective compliance program. As with the Sentencing Guidelines, AS 3806 focuses on essential components and leaves it to individual companies to determine how best to implement effective compliance programs given the nature and requirements of their respective organizations. Specifically, AS 3806 states that a compliance program is an important element in the corporate governance and due diligence of an organization, and should:

- aim to prevent, and where necessary, identify and respond to, breaches of laws, regulations, and codes of organizational standards occurring in the organization;
- promote a culture of compliance within the organization; and
- assist the organization in remaining or becoming a good corporate citizen.¹

This Australian standard also provides a definition of corporate culture:

[Continued on page 3]

and controlled” with respect to a company’s anti-bribery standards.

South Korea — Under South Korean law, companies are not subject to sanctions for bribing a foreign public official if they have “paid due attention or exercised proper supervision to prevent the offense.” There is a difference of opinion as to what constitutes compliance with this directive. An explanatory manual published by the Ministry of Justice suggests that merely having a policy against bribery would suffice, which the OECD Working Group indicates may be an unduly lenient test.

The confluence of three developments has resulted in a global trend that encourages and increasingly mandates the development and implementation of company systems for the prevention, detection, and, if necessary, cooperation in the prosecution, of wrongful corporate conduct:

- legislative change in some countries that permits the prosecution of companies for behavior for which heretofore only individuals could be held criminally liable;
- national law (1977 Foreign Corrupt Practices Act) and international conventions and working groups (e.g. 1997 OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions) that criminalize business conduct outside the company’s home country; and
- the more efficient outcomes resulting from a significant transfer of the compliance burden from the governmental officials to the institutions subject to the laws and regulations.

At the same time, the experience in the United States with what had started as a pure “compliance” regime may be leading to the development of a “third way” in which companies are encouraged to use strong compliance structures in the service of a broader ethical mandates.

Notes

1. Australian Standard AS3806 – 1998, Compliance Programs, Standards Australia, p. 4. *See also*, remarks of Gayle Hill, 9th International Anti-corruption Conference, Durban, South Africa, (1999).
2. *Ibid.*
3. *ACCC v. Real Estate Institute of Western Australia* (1999), *ACCC v. Rural Press* (2001); Although the Australian Courts have expressed reservations about 3806, the Australian equivalent of the SEC has told regulated companies to use it.
4. Christine Parker, “Section 8: Is There a Reliable Way to Evaluation Organizational Compliance Programs?” *Regulation: Enforcement and Compliance*, Australia Institute of Criminology, 2004.
5. “Is Your Organisation Complying?” *Litigation & Dispute Resolution*, Thompson Playford (August 2006) www.thompsonplayford.com.au.
6. “AS3806 – Practical Implications of the 12 Principles – What Does it Mean for You?” *Deloitte Regulatory Review*, May 2006, p. 2. www.deloitte.com.au.
7. Jean-Francois Arvis and Ronald E. Berenbeim, *Fighting Corruption in East Asia – Solutions from the Private Sector*, (the World Bank, 2003), p. 37.
8. Trib. Milano, sez XI Giud. Riesame, Pres. Rel. Mannocci, ord. 10-28-2004, Siemens, AG, as quoted in Francesca Chiara Bevilacqua, “Corporate Compliance Programs under Italian Law,” *Ethikos and Corporate Conduct Quarterly*, November/December 2006, Case Citations are from Ms. Bevilacqua’s article.
9. Francesca Chiara Bevilacqua, “Corporate Compliance Programs under Italian Law,” *Ethikos and Corporate Conduct Quarterly*, November/December 2006. <http://ethikosjournal.com/html/italy.html>.
10. *Ibid.* Unlike the first poll, the later survey has a participant industry breakdown. Twenty-five were lending institutions or financial intermediaries, 11 were insurance companies, 16 were industrial companies, 16 were utilities and four were in the media/telecommunications sector. Possibly owing to this sample distribution, the participants identified “public administration” (meaning anti-corruption issues) as the key risk and tailored their programs accordingly.
11. *Ibid.*
12. “How Your Business Can Achieve Compliance – A Guide to Achieving Compliance with Competition Law”, Office of Fair Trading, 2005. p. 10.
13. The OECD Anti-Corruption Convention (1997) provides for country review by other convention signatories. The Norway country report and that of the 35 other country signatories including non-OECD countries (e.g. Bulgaria, Chile) can be found on the OECD’s website at www.oecd.org.

\$1 Trillion in the Side Pocket – Avoiding and Resolving Hedge Fund Disputes

By Micalyn S. Harris

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The recent growth of hedge funds has been phenomenal. It’s estimated that hedge funds currently have \$1.5 trillion under management – some 1% of the world’s financial assets.¹ Through use of leverage, they may actually control as much as 3% of the world’s financial assets. They are reported to account for somewhere between 25% and 60% of trading on global major markets, and for 15-20% of investment bank revenues.² They are significant creators and market makers in a broad range of derivatives. In short, they have become of major importance not only to their creators, managers and investors, but to the global financial markets – banks, broker-dealers, insurance companies, and those who use their services. These include public companies issuing private debt, with or without equity kickers such as rights or warrants, and private companies looking for financing. Thus, hedge funds influence not only the companies in which they invest and derivatives based on those companies’ securities, but also those companies’ customers and suppliers. Directly or

indirectly, hedge funds have an impact on a substantial and growing portion of global commerce. They are a significant component of the world's financial systems and becoming increasingly significant.

Hedge funds are often regarded as exotic creatures confined to a small niche of the financial and commercial world. If estimates are even approximately correct however, these funds are expanding at an astounding rate. One commentator estimates that there are currently about 9,800 hedge funds in operation, and an average of three launched each working day.³ With such growth, it is increasingly likely that as lawyers, we will be confronted in some way with a matter involving a hedge fund.

As lawyers, we are engaged in planning for, avoiding and participating in an adversarial process. Accordingly, the materials include a brief description of when, where and what problems and conflicts are likely to arise in connection with hedge funds, and how those conflicts are likely to be resolved.

Definition of a Hedge Fund

Hedge funds are not new. The term can be traced back to Alfred Winslow Jones, who, in 1949, founded a “hedged fund”, that is, a fund he described as selling some securities long and others short in order to “hedge” his investment portfolio and thereby reduce investment risk. Today, the term “hedge fund” is often used to refer to private equity pools of capital using a wide range of investment strategies. These pools of private capital – hedge funds – may invest in publicly-traded securities, including options, futures, and other derivatives, using long-short hedging strategies or other strategies.⁴ Where the strategies employed involve traditional hedging strategies utilizing investments in publicly-traded securities (including derivatives), such pools of capital are highly liquid at all times.

Hedge fund strategies may also provide capital in the form of private equity to public and private companies by creating non-public securities. Such non-public securities may take a variety of forms and structures. For example, they may take the form of convertible debt securities repayable in part with publicly-traded common stock of the company and obligating the company to issue additional shares of common stock if the shares repaying the debt fall below a certain price. Another possible structure when investing in a privately-held company is for the hedge fund to take equity securities with warrants or rights to acquire additional shares when the company goes public. Formulas for the number of additional shares can be complex in order to take into account a variety of factors such as the leveraged buyout offering price and the time elapsed from issuance of the original shares to going public. Many other arrangements are available, each reflected in the creation of a sometimes unconventional, sometimes unique security.

The structures utilized to own and distribute these securities may also take a variety of forms. For example, a public company may create a special class of securities

that is purchased by an entity – an investment vehicle– created for the sole purpose of buying and distributing them. Alternatively, such an investment vehicle may take the securities for investment, and issue interests in itself, which interests are then purchased by a hedge fund or several hedge funds, or by the hedge fund manager which then resells the securities to the hedge funds. In these examples, there is no public market for either the special class of securities issued by the public company or the interests in the investment vehicle that owns that special class of securities. Under this and similar such arrangements, so long as the securities are private and there is no market for them, they are not liquid and there is no readily-available measure of their fair market value. That has implications for valuation of the securities, and for calculations, such as management fees, that depend upon the value of the securities held by the fund.

How Are Hedge Funds Different?

The private equity aspect of hedge funds is one difference between hedge funds and other investment pools such as mutual funds and ETFs (exchange-traded funds – baskets of investments traded as units). There are others. Hedge funds are expected to earn outsized returns. To achieve these returns, hedge funds must take outsized risks. Moreover, hedge funds often regard their investment strategies as trade secrets. These characteristics have led regulators, at least in the United States, to conclude that hedge funds are appropriate only for wealthy and sophisticated investors. As a practical matter, at least in the United States, “sophisticated” is defined and measured by liquid personal wealth, under the theory that anyone accumulating a certain level of personal wealth is also either sophisticated about investing or can hire someone who is sufficiently knowledgeable to evaluate the investor's ability to take the investment risks associated with hedge funds and/or the investor's ability to withstand loss of its entire investment.⁵ Because hedge funds are managed by sophisticated investors and their limited partners or unit holders are also sophisticated investors, U.S. regulators have taken the position that hedge funds and the securities they create (so long as they are not offered to the general investing public) can be more lightly regulated than publicly-traded securities. Lighter regulation means less disclosure. And less disclosure means that trust is key: an investor's decision to invest in a hedge fund is based primarily on a belief in the hedge fund manager's ability to produce outsized returns.

What Does It Take to Meet Investor Expectations?

How “outsized” must a hedge fund's return be to meet investors' expectations of an “outsized” return? It has been estimated that annual transaction costs for a hedge fund run to about 4% of assets, and that management salaries and fees (typically a base of 2% of assets under management plus 20% of profits realized) add another 4-5% annually.⁶ If an “outsized return” is a return over 10% — a relatively modest level — hedge funds need to realize annual returns of at least 20% in order to meet their investors' expectations.

When and What Problems Are Likely to Arise?

So long as a hedge fund is meeting its investors' expectations, whatever its internal operations or strategies, investors are likely to be satisfied. Problems are most likely to arise when a hedge fund is not meeting its investors' expectations. Problems may also arise when monthly reports contain warning signs suggesting that returns are or are likely to be in jeopardy, for example, when they show increased deductions for costs such as legal or accounting fees, or increased reserves for such fees. Problems may also arise when an investor decides, for reasons unrelated to fund performance, to withdraw funds. Finally, problems may arise when a limited partner or withdrawn partner, in order to verify the value of its investment or the withdrawn portion of its original investment or for other reasons, demands more information than routine reports provide.

Valuation of Investors' Interests

Most problems arise in connection with valuation of interests in a fund, frequently although not exclusively on partial redemption or withdrawal of a limited partner. Obtaining the basic information required to calculate hedge fund profit and loss over time in order to verify the value of the interest of a participating or withdrawing investor seems, at first blush, to be straightforward, but it can be challenging. In order to understand why, it is necessary to understand how these funds are organized and to consider how flexible and various fund structures and investment arrangements can be.

In the United States, hedge funds are typically organized as limited partnerships.⁷ The general partner of the limited partnership, typically organized as a limited liability company, is the fund manager. The investors are limited partners. (If the fund is organized as a trust, the investors are unit holders. Whatever the form, the investors are passive investors and the fund manager makes investment decisions for the fund. For tax reasons, in the U.S., hedge funds are usually not organized as C corporations.) The rights and obligations of all partners and the partnership, as well as the manner in which interests in the partnership will be issued, distributed and accounted for, procedures for joining and withdrawing from the partnership, rights of the limited partners on withdrawal, and how disputes among partners and with the partnership shall be resolved are all matters of contract, set forth and governed by the terms and provisions of the limited partnership agreement (or trust agreement) and applicable law.⁸ The partnership agreement is likely to include the terms, conditions and representations of a subscription agreement pursuant to which limited partners invest in the partnership.

If U.S. investors are participating in the fund, the fund manager (general partner) will also provide prospective investors with a private offering memorandum in order to comply with U.S. federal securities laws. Typically, this memorandum will outline investment approaches and risks in more detail than the partnership agreement. Also

typically, the subscription agreement will require investors to acknowledge reading and understanding the private offering memorandum, but in general, the memorandum will not be part of the contract governing the rights and obligations of the partners and the partnership.

Hedge funds traditionally make certain promises to their investors. For example, they promise limited partners that they can, on five days notice, withdraw 90% of the value of their investment (or distributive interest), and the balance after verification by an independent outside auditor. These independent audits may be made quarterly or more typically at the end of the partnership's fiscal year. When a traditional hedge fund invests in publicly-traded securities, the value of the investments is easily verified and the promise of prompt payment of that value can, in most circumstances, be easily fulfilled. When investments are made in both liquid and non-liquid securities and all partners participate in a common pool of investments, the liquid securities can be sold to meet redemption demands, at least up to a point. If the value of the fund is declining, there may be a race to the exits, with the last partners left unable to redeem their interests.

When a hedge fund's investments are made in securities that are not publicly traded, rapid redemption may not be possible and valuation may be difficult. To deal with the problem of valuation, the partnership agreement may provide that the fund's clearing agent or an independent broker-dealer shall establish a fair market value for all non-public securities held by the fund, quarterly in connection with calculating management fees and upon redemption and withdrawal of a limited partner. To deal with predictable difficulties in redeeming illiquid securities, the partnership agreement may give the general partner the right to delay redemption (payment) for a defined period, usually a short time such as three months, or to delay redemption up to a limited time period where, in the judgment of the general partner, redemption by one limited partner will be unfair to the others. A general partner might wish to have no time limit on obligations to redeem, especially when securities are illiquid. In order to sell interests in the fund however, it may be necessary to offer investors the traditional assurance that they can withdraw from the fund when they wish to do so, or within a reasonable time after requesting withdrawal, and to provide some means for investors to verify the value of their interests on withdrawal.

When investments are illiquid, rapid redemption, or even limited delayed redemption, may not be possible. Where the partnership agreement so provides and assets are transferable, redemption in kind may be permitted. Alternatively, where it is anticipated that the securities will be non-transferable, the partnership agreement may provide that upon withdrawal, the withdrawing partner has the right to be paid the value of its investment but has no further interest in the assets of the partnership. In the latter case, the obligation to make payment becomes a debt of the partnership without immediate recourse to specific assets. If a sufficient number of limited partners withdraw and cannot be paid, the partnership may become insolvent.

Valuation of Investors' Interests; Side-Pocket Investing

Pools of private equity may consist of a common pool of securities, liquid or illiquid, in which partners (or unit holders if the fund is organized as an investment trust) share in accordance with their respective investments. Some hedge funds however are organized as a series of separate investments in which one or more but not all partners invest. For example, a fund may provide that as new investors join, they will participate only in investments going forward, or a fund may give some but not all partners interests in certain securities. Such arrangements involve so-called "side pocket" accounting (picture a pool table with side pockets).⁹

Side-pocket investing gives rise to complicated accounting and other problems. The net asset value of the partnership as a whole cannot be used as a basis for calculating the net asset value of the aliquot share of each partner because to the extent that different partners have joined at different times and/or participate in different investments, the value of each partner's interest will differ; it cannot be measured as some portion of a common pool. Side-pocket investing that involves non-publicly-traded securities creates further complications in connection with calculating management fees based on a percentage of the "fair market value" of securities under management. The partnership agreement may provide for a quarterly independent statement of fair market value of non-publicly traded securities by a clearing agent or broker-dealer for the fund and the accounting provisions of the partnership agreement may then provide for each side pocket to pay management fees based on the value of its side-pocket account.¹⁰ When the agreement is silent as to how management fees are to be allocated, the valuation may also involve demands for information on and challenges to the fairness of the method used by the general partner to allocate fees among the fund's side-pocket accounts.

Further complications may arise when a fund offers limited partners the right to invest only in deals going forward. When a limited partner withdraws, what happens to the securities in the withdrawn limited partner's "side-pocket"? If the securities cannot be sold, how will that withdrawn limited partner be paid? Will funds be available from new limited partner(s)? Will new limited partners then "invest" in the securities formerly in the withdrawn partner's side-pocket? If so, at the price the securities were originally acquired by the withdrawn partner, or the current fair market value of the securities? What if there are no new partners to provide funds to pay the withdrawn partner?

Valuation of partnership interests is also affected by deductions for reserves for litigation and related accounting and other fees. When a partnership finds itself involved in litigation, decisions must be made as to whether litigation costs and reserves should be borne solely by the side-pockets involved in the particular investment giving rise to litigation, or by all of the partners in accordance with the amount of their respective initial investments, or possibly on some other basis. If the governing documents are silent on how

to allocate deductions for such reserves, the general partner will decide. Whatever the decision, to the extent that there were alternatives, the general partner's decision will inevitably work to the disadvantage some limited partners and the advantage of others. As a result, silence as to how reserves are to be allocated may give rise to another issue for dispute and demands for additional information, and provide another basis for challenging fairness to the investors unfavorably affected by the general partner's chosen method of allocating litigation reserves and related accounting and other fees and expenses.

Conflicts of Interest

When the general partner is acting as investment manager of more than one fund and investments sour, the general partner may be accused of conflicts of interest that resulted in unfairly distributing investment opportunities among the funds it manages. Such accusations are particularly likely to be made when management fee arrangements are different for different funds managed by the same general partner. Disappointed investors may thus challenge the general partner's decisions allocating various investment opportunities not only among partners in a particular fund using side-pocket accounting but also the allocation of investment opportunities among the several funds the general partner is managing. If the general partner is accused of improper behavior, further questions arise as to whether the fund or the fund manager should shoulder the legal and accounting fees and other costs involved in any litigation to which the allegedly improper activity gave rise.

Conflicts Regarding Investors' Access to Information

Whenever there are questions or problems, and the above description of possible conflicts is far from an exhaustive list, hedge fund investors will want information enabling them to verify information previously received such as monthly reports, and more than likely, will also want more and more detailed information than they previously received.

Limited partnership agreements typically give limited partners access to "the books and records" if not "all of the books and records" of the partnership, and upon withdrawal, access to sufficient books and records, or perhaps "records and other data" sufficient to enable the withdrawing partner to verify that the amount being paid accurately reflects the current value of that partner's interest in the fund.

What Are the "Books and Records" of a Fund?

In today's world, "books and records" include books and recorded information, regardless of the medium and format in which the information is recorded and maintained. "Books and records" can be reasonably interpreted to include traditional books such as minute books, accounting ledgers and records in all forms, e.g. paper documents, digital records, information in databases relating to transactions in which a partnership engages, and other records and

information maintained by that partnership, whether or not the partnership is required to keep that information and whether the information is in paper files or in some other medium such as a database that must be “queried” to elicit information.

Given the typically complex nature of hedge fund investments and the sophistication of hedge fund managers and investors, traditional physical “books” with ledgers containing numbers, even in the form of computer printouts, often do not exist. The “books” of a hedge fund are likely to consist of a database maintained by the general partner on behalf of the partnership, and a set of programs that “query” the database to produce whatever information is routinely needed.¹¹

What Does “Access” to Books and Records Mean?

Traditionally, one provided access to an organization’s books and records by gathering together the corporate minute books and accounting and other physical journals and ledgers, putting them on a table or desk in a room or otherwise vacant office and giving the examiner the opportunity to examine those physical documents. Giving someone, even a technically sophisticated someone, access to a database is different from giving someone access to physical journals and ledgers.

Where information is in a database, “access” is generally not meaningful in the absence of technical information about how that database is structured and organized. As stated above, information is extracted from a database by “querying” the database. In order to formulate specific queries, for example to be made to a fund’s database (or databases) to obtain information needed to establish an investor’s distributive interest, a third-party technical expert would need detailed information regarding the nomenclature used to describe various fields in the database, the structure of the database, the names used to describe reports for which queries exist, and related technical information and expertise.

Additional challenges may arise if the nomenclature of the governing documents and the nomenclature of the database do not correspond. Suppose for example, that the governing document is a partnership agreement that requires the general partner to provide each limited partner with a quarterly report of the “book capital value” and the “tax capital value” of its interest but instead, each limited partner has been given a report of the “net asset value” of its interest. Whether “book capital value” and “net asset value” are the same will require an analysis of the partnership agreement’s descriptions of what the two terms mean and how their respective values are to be calculated. That analysis will likely be made by a lawyer with a financial background, perhaps with the assistance of a certified public accountant if the agreement calls for calculations to be made in accordance with generally accepted accounting principles. Whether the algorithms used by a database query to calculate net asset value and book capital value make the calculation in accordance with the document may take a combination of

legal and technical expertise. Under ideal conditions, at the outset, lawyer, accountant and database architect would have worked together to assure that database queries elicit the information required to be reported in accordance with the undertakings in the governing documents.

Finally, if investment vehicles have been used as described above, the books and records of the limited partnership may reflect only the names, number of shares purchased, and price paid for the interests in the investment vehicles. In that case, access to the books and records of the general partner and/or the investment vehicles will be necessary in order to determine the nature of the fund’s investments.

Conflict Resolution

The governing documents of most hedge funds provide that disputes arising under them will be resolved by arbitration. Arbitration of hedge fund disputes has the advantages of arbitration for disputes in general and international disputes in particular. Parties can, by contract, choose the governing law, procedural rules, forum and language in which hearings will be conducted. The process is private rather than public – an attribute that may be particularly important to hedge fund managers who believe their strategies are proprietary and deserving of protection as trade secrets. The process is less formal than litigation in a court of law, and therefore likely to be speedier and less costly than courtroom litigation.

Perhaps most significantly, arbitration permits the parties to select the members of the tribunal asked to resolve the dispute and impose performance requirements and limitations on their authority.

Choosing an arbitrator or panel of arbitrators familiar with hedge fund structures, operations and related legal, accounting and technical issues and requirements can save time and improve results. In a court of law, the parties may find themselves before a judge who is an expert on environmental matters or medical malpractice but has little or no experience with corporate finance, U.S. federal or other applicable securities laws, hedge fund operations and investing, or the use of databases for accounting purposes, thus presenting litigants with the need to educate the court in many areas before reaching the merits of their specific dispute. With arbitration, the parties can choose a tribunal that is knowledgeable in these areas, thus enabling the parties to address the merits of their specific dispute more quickly and the tribunal to reach a resolution more quickly and at less expense in terms of both time and money. The sophisticated tribunal may also be more articulate and aware of second-level implications and effects of its rulings and where a written opinion is required, provide a more articulate discussion than would a court previously unfamiliar with the issues and challenges involved in hedge fund investing, management and reporting.

Arbitration also enables hedge fund managers to impose limits and requirements on the chosen tribunal. For example, an arbitration clause may state that the tribunal’s authority is limited to construing and enforcing the terms

and conditions of the governing agreement, that the reasons for the tribunal's award must be stated in a written opinion (also called a "reasoned award"), that the award shall not alter, modify, cancel or rescind any term or condition of the governing agreement, that the award must be consistent with the provisions of the governing agreement, and that the award shall be a final and binding judgment that may be confirmed and entered of record in any court of competent jurisdiction. Because these requirements and limitations are contractual, the disputing parties may also mutually agree to amend them. For example, an arbitration clause may require a three-person tribunal but the parties may decide that one arbitrator is sufficient and to reduce costs by going forward with a tribunal of one rather than three arbitrators.

A tribunal faced with disputants in a hedge fund case may have to be sensitive to and consider dealing with a number of practical problems. For example, where the nomenclature of the documents does not coincide with the nomenclature used in routine reports provided by the fund's database, if a general partner is required to provide specified information, a well-crafted reasoned award will describe the data required to be provided in general terms, with the understanding that use of particular terms does not preclude providing the data and information necessary to produce the described result regardless of whether the relevant database uses those terms or the information is elicited by using the particular language of the descriptions in the award. A knowledgeable tribunal will also recognize that no database manager is comfortable giving someone unfamiliar with that database unlimited access to it, and that even a technically-adept third party is likely to need cooperation from the database manager or administrator in order to make access useful for the purpose of verifying the accuracy of calculations relating to the value of a partnership interest. For that reason, a sensitive tribunal will explore and determine whether the fund manager, if ordered by the tribunal to provide clearly defined specific information, is likely to provide that information, and consider whether to include in its order a provision that if the fund or fund manager fails to cooperate by providing the information required by the order, e.g. "to the satisfaction of the limited partner", the tribunal will order the fund to give a third party unfettered access to a fund's database(s) or even a limited portion of a fund's and/or fund manager's database(s).

Conclusion

The growth of hedge funds over the past five years has been phenomenal. Today, they account for an increasing portion of assets under management, liquidity of securities markets and revenues of financial institutions. As they continue to grow, the types of securities they create and trade are likely to become more complex, their impact on the financial community is likely to increase, and the scope of their influence is likely to expand further. Performance expectations are likely to remain high, perhaps unrealistically high as increasing competition makes it necessary to take greater risks to meet investors' expectations. Predictably, the high expectations that are the hallmark of hedge funds will periodically be unmet. Conflicts will arise.

Lawyers who have thoroughly understood the financial arrangements their clients are planning and the need for supervising implementation of systems and procedures to assure their clients meet the obligations of the documents their lawyers create are likely to serve their hedge fund and financial service industry clients well. Such lawyers will minimize the risk of conflict in the event of disappointment and when conflict is unavoidable, will have provided detailed methods for efficient and effective conflict resolution.

The costs of resolving conflicts can be reduced by providing for arbitration, outlining the scope of an arbitration panel's authority, and choosing arbitrators who are familiar with hedge fund documents, structures, relevant laws, and the technology used to manage hedge fund operations. Choosing such arbitrators can help assure efficient, practical and speedy conflict resolution.

Notes

1. Andy Kessler, "Hedge Fund of Funds", *The Wall Street Journal*, February 7, 2007, p. A15, col. 6.
2. *Barron's*, February 12, 2007, p. 8, col. 3.
3. See *Barron's*, February 26, 2007, p. 37, col. 4.
4. For purposes of this discussion, the term "hedge fund" is used in its expanded sense, i.e., interchangeably with a pool of private equity managed using a variety of investment strategies that may or may not include hedging.
5. Currently, hedge funds operating in the U.S. under the Investment Company Act of 1940 can raise money in the U.S. in the form of a 3(c)1 fund, which requires there be not more than 100 investors each with a net worth of \$2.5 million excluding primary personal residence or in a 3(c)7 fund with no limit on the number of investors, each with a net worth of \$5 million. See "Hedge Funds Walk a Hard Line Between Silence and Sharing", *New York Times*, February 9, 2007, p. 7, col. 3.
6. *Financial Times*, February 8, 2007, p. 9, col. 4.
7. These limited partnerships are often organized under the Delaware Revised Uniform Limited Partnership Act ("DRULPA") because Delaware law is friendly to and well-developed regarding these entities.
8. Where a fund is organized as a limited partnership, the fund manager will be the general partner and the investors will be limited partners. Where the fund is organized as a unit trust, the fund manager will be the trustee or managing director and the investors will be unit holders. Solely for the convenience of discussion, the terms "fund manager" and "general partner" will be used interchangeably, as will the terms "investor" and "limited partner" and are intended to include their counterparts when funds are organized as unit trusts or other forms of entities, recognizing that there are some differences in the rights and obligations of all participants depending upon the type of entity and documents under which it is formed.
9. The title of this paper derives from an extended meaning of "side-pocket accounting". Research reveals no estimates of the percentage of hedge funds that organize investments in side pockets rather than a having all of their investors participate in a common pool of investments. By their nature as private equity however, most hedge fund investments are difficult to track, as they are not often part of calculations of companies' "public floats" of securities. Hence, by extension, hedge funds can be seen as representing and controlling assets in the side-pocket.
10. Even independent valuations are subject to uncertainty and therefore challenge. In the absence of a public market or actual offer, acceptance and pending sale of a security to a prospective

qualified buyer, an independent valuation is a matter of the evaluator's judgment, at best supported by comparison with similar but probably not identical securities.

11. Picture a pigeon-hole desk with a single piece of data, e.g. name of an investment vehicle, date of formation, security issued, date of each issuance, etc. in each cubicle. This is the database. The programs that organize these discrete pieces of data to produce information, usually in the form of reports, are called "queries". A fund will have a set of queries that produce routine reports. Additional queries (computer programs) can be written to produce additional reports, and to determine whether the reports actually provide the information or make the calculations they are intended or purport to provide or make.

Board Evaluations – How & Why

A Thomson Financial Survey with comment by Glenn Curtis

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In 2004, the New York Stock Exchange adopted new corporate governance rules which require that boards of listed companies conduct annual self evaluations. The purpose of these assessments is to determine how effectively the board and its committees are functioning and to determine if the board is living up to its fiduciary responsibilities to shareholders. (Note that the Nasdaq Stock Market does not currently require that listed companies conduct a formal evaluation although many companies often chose to do so.)

More specifically, (self) board evaluations are meant to help identify if the board is lacking in any area of expertise, and/or is using its time efficiently. They also provide individual board members and committees with specific feedback on their performance, which in turn can be used to develop self improvement plans. Finally, and perhaps most importantly, the evaluation process demonstrates for investors that the board is working to improve its governance skills, and by extension shareholder value. In that sense, the process may be considered invaluable.

The current NYSE rules stipulate that a nominating committee made up of independent directors must oversee the evaluation process, and that specific evaluations must be made of the audit, compensation, and corporate governance committees. After completing a self evaluation the listed company typically reveals the existence of a process, and then provides a brief outline of it in its annual proxy statement. The results, however, are not published.

Where the NYSE rules fall short, however, is that they do not specify how the evaluation process should take place, the questions that should be asked, or the format for the assessment. In short, it is up to individual boards to formulate their own plan for evaluation.

Of course, this is easier said than done. A number of consequences must be considered before instituting any board evaluation program. For example, some board members

might resent being evaluated by their peers, or the time it takes to conduct the process.

Then there is the potential impact on unit cohesiveness. What would happen to the group's ability to work together if one or two board members were to receive an unusually harsh review from their peers? Would that wreck the collegial atmosphere or cause animosity among the group?

With that in mind, there are several things that companies can do to get their directors on board with the self evaluation process. First, rather than focus solely on individual performance (although that is important to evaluate as we will discuss later on), the evaluation process should primarily revolve around group dynamics. In other words, the evaluation should focus on questions and issues such as:

- What are the board's strengths and weaknesses?
- Does the compensation committee (for example) meet often enough to fulfill its duties?
- Does a particular committee receive and process information in an efficient manner?

Again, by focusing the majority of the evaluation process on the group's progress, as opposed to the individual's performance, directors can feel more at ease with the process.

Second, many companies make the evaluation process more appealing (to directors) by emphasizing that the process is being undertaken to improve the board's "efficiency." In fact, to directors that feel overworked and underpaid, that is usually the best selling point.

With regards to group cohesiveness, far too often directors are asked to sit on boards where the atmosphere is not collegial, or where there is a lack of communication between individual board members. However, the evaluation process can help to improve the communication process by pointing out these deficiencies and demonstrating how they are hindering performance of certain committees or the board as a whole.

The third and best way to get board members enthusiastic about the process is to have them design or to assist in designing the evaluation. (Note: According to a survey conducted by Thomson Financial, 78.2% of respondents indicated that their boards helped to construct the evaluation process.) To that end, many boards either work independently, or with an outside party to develop a list of topics that might be analyzed, and create the process (surveys, interviews etc.) by which the evaluation will take place.

There are benefits to designing the process internally. The most obvious is that it is cheaper than retaining outside counsel. In addition to the cost savings, logic dictates that the board knows the company better than any outside party. As such it should be better equipped to come up with a format to identify and assess the issues and concerns facing it. However, a third party, particularly if it has extensive experience within the industry, may provide the board with a fresh perspective and can often complement internal efforts.