KAYE SCHOLER LLP

INVESTMENT FUNDS NEWSLETTER

U.S. Hedge Fund Managers Under Scrutiny

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The recent worldwide economic crisis has battered the hedge fund industry and increased scrutiny on many individual fund managers. While the total financial impact of the current crisis remains uncertain, the long-term regulatory impact on the way hedge funds conduct their businesses may prove to be even more significant.

In his opening remarks before a U.S. House Committee on Oversight and Government Reform, Representative Tom Davis of Virginia warned that, "[g]oing forward, hedge funds will have to take account of a reduced tolerance by investors and governments for an unregulated parallel financial universe of exotic derivatives." Rep. Davis' remarks set the stage as five prominent hedge fund managers were called to testify in public hearings before the committee organized to help determine the cause of the current financial crisis and map out legislative solutions. Most observers agree that hedge funds will face tighter regulation and more aggressive enforcement in the coming year.

Until recently, government regulators kept a wide berth from the hedge fund industry. Hedge funds were viewed as complex investment vehicles for savvy investors who could take care of themselves. As the size of the hedge fund industry has grown — reportedly to almost $3 trillion — regulators have begun to take a different tact. Following this summer's indictment of two former Bear Stearns portfolio managers, SEC Chairman Christopher Cox declared that "hedge funds are by no means unregulated when it comes to fraud." The message implicit in Cox' statement is that government regulators and enforcement agencies will aggressively protect the market, not just the average investor, from fraud and false statements. Accordingly, in the past several months, private investment funds have faced ramped-up enforcement efforts by U.S. authorities: the SEC recently began an internal self-education agenda with respect to private investments and established a Hedge Fund Working Group to target ongoing concerns; numerous U.S. Attorney's Offices have begun following or working in parallel with the SEC on private investment prosecutions; and the FBI is beginning to move case agents from national security assignments back to criminal investigations involving financial crimes. The "unregulated" nature of private investment funds is facing dramatic changes.

Enforcement Trends

The most significant enforcement trend currently facing private investment funds is the government's increased scrutiny of disclosures — both formal and informal — to a fund's investors. While the disclosure regime for private investment vehicles is significantly less formalistic than for a publicly traded company, the pitfalls for false or misleading disclosures can be just as dangerous. Securities regulators are being encouraged to make use of the relatively recent "anti-fraud" rule, while federal prosecutors have expanded their use of traditional mail and wire fraud theories of liability to encompass allegedly false disclosures to investors.

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For example, in the recent Bear Stearns indictments, prosecutors alleged that managers misled investors about the financial condition of their funds through a series of false disclosures. The disclosures included statements about the exposure of the funds to subprime mortgage-backed securities, expected redemptions, the performance of the funds, and the managers' personal investments in the funds. Prosecutors focused on a series of internal e-mails among members of the funds' portfolio management team, describing the difficult financial prospects facing the fund. These internal discussions were contrasted with representations made to individual investors touting the funds' liquidity position and long-range prospects. The government also focused on statements made to the funds' investors in a conference call, during which the funds' managers allegedly failed to provide investors with a complete and accurate picture of the large number of anticipated redemptions, as well as a reduction in the personal stakes invested by the funds' managers.

Similarly, three U.S. Attorney's Offices are currently investigating whether senior executives at Lehman Brothers misled investors about the financial condition of that company prior to bankruptcy. Prosecutors appear to be focusing on evidence of conflicting viewpoints within senior management, suggesting that public disclosures regarding the liquidity of the firm and the nature of its portfolio were inaccurate or fraudulent. In both the Bear Stearns indictment and the Lehman Brothers investigation, the government's focus has little or nothing to do with the conduct that caused these firms' collapses. Instead, federal regulators are painstakingly sifting through the wreckage to see whether false statements were made to investors or whether material facts were omitted.

Given the recent volatility in the markets, regulators are also looking closely at allegations of insider trading and improper short-selling techniques. Enforcement authorities have shown a particular interest in Private Investment in Public Equity ("PIPE") transactions and insider trading opportunities. Even before the highly-publicized SEC action against Dallas Mavericks owner Mark Cuban, authorities were targeting individuals and entities who traded in securities based on information that was not publicly available to the market. While such actions generally require the breach of a fiduciary duty, regulators have taken an increasingly expansive view of this requirement.

While most investors in private funds are considered to be "sophisticated," fund managers still need to ensure that certain investors are not being given preferential treatment at the expense of other investors. Generally, as a consequence of the trust and reliance involved in the relationship between a fund manager and an investor, the manager could be deemed a "fiduciary" of the investor. This fiduciary status results in a duty of loyalty being owed from manager to client. Part of the manager's duty is a loyalty to the client not to place himself in a position where his duty to one investor conflicts with his duty to another. It follows from this that a manager must treat clients of the same class equally as to both services and information. It is not difficult to envision how prosecutors and regulators would fashion "honest services" fraud charges based on a violation of this duty in the form of asymmetrical dissemination of information to investors.

Enforcement Trends

What lessons can be taken from these trends in government enforcement? First and foremost, fund managers need to be extremely vigilant about the disclosures they are making to investors, focusing on how they are answering investor inquires and what information they are releasing to the market-place. In most instances, private fund managers do not have the same regulatory obligations to make public disclosures as public companies or registered firms. This means that when fund managers do make disclosures, they should be carefully coordinated and completely accurate. Half-truths and slanted disclosures are the quickest way to draw the ire and attention of federal regulators.

Additionally, managers need to be wary of providing disclosures selectively among their clients. If disclosures are made, they should be made to all investors and the information provided should be consistent. Perhaps taking counsel from this recent enforcement trend, on October 15, 2008, the head of Citadel sent a letter to all of his investors that declared that September was the "single worst month, by far, in the history of Citadel. Our performance reflected extraordinary market conditions that I did not fully anticipate, combined with regulatory changes driven more by populism than policy." Admissions like these may not be desirable from a business standpoint, but they leave regulators little opportunity to argue that investors were misled or that fiduciary duties were not upheld across the board.

Fund managers need to take notice of the new regulatory environment in which they are operating. Regulators are looking to tighten their grips on the private investment industry and fund managers need to operate with a greater sense of caution and care. While fund managers cannot undo the damage that has been done by the current financial crisis, they can take steps to protect themselves against the growing number of regulatory and legal pitfalls they face.

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Private Equity Funds in China: A Legal Puzzle

The market for private equity in China has undergone dramatic changes during the past decade. Full of risks and opportunities, the Chinese private equity market has been evolving since the late 1990s, when private equity funds were virtually nonexistent, to the present, where we have seen serious efforts from the Chinese government to promote this type of investment activity in China, despite the challenges involved.

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Given the short history of private equity industry in China, experienced fund managers are scarce. This may create opportunities for experienced international private equity industry players to play a role in China's growing private equity industry.

Private equity initially became popular among Chinese enterprises that needed capital, western management skills and know-how, and access to the international capital markets. Due to China's vast size and rapid economic growth, major international private equity firms have formed funds targeting investments in China and have established a presence in the greater China region. Domestically, Chinese capital, inspired by the success stories of international private equity funds, has also been looking for its own private equity outlets through the formation of principally domestically-owned and -managed private equity funds in offshore jurisdictions targeting investments in China, the formation of RMB-denominated funds under China's experimental venture capital regulatory regime, and through the creation of the first few RMB-denominated private equity funds under China's Amended Partnership Law. Recently, we have seen additional efforts from the Chinese authorities to encourage the development of the private equity investment industry in China.

To fully understand the challenges and opportunities facing the Chinese private equity market, it is important to have a general understanding of the legal framework surrounding the RMB-denominated private equity investment industry in China.

Legislative development in the area of investment funds started in the late 1990s in tandem with the building and development of China's capital markets, which was marked by the re-opening of the Shanghai Stock Exchange for trading in December 1990, the establishment of the China Securities Regulatory Commission in 1992, and the enactment of the *Securities Law of the People's Republic of China* in 1998. The initial focus of legislative development in the area of investment funds was to provide a legal platform and a regulatory framework for the formation, management, investment and termination of funds investing in publicly-traded securities in China. Since the early 2000s, there have been legislative efforts to promulgate a legislation that would specifically authorize and regulate the formation, management and operation of private equity funds. Unfortunately, although there is still much anticipation for the passage of such legislation, no specific timetable has been set at the moment.

This delay in the enactment of a specific private equity regulation resulted in various PRC ministerial-level authorities and local governments issuing their own regulations authorizing and regulating the formation, management and operation of investment funds. The 2003 *Administrative Regulations on the Foreign Invested Venture Capital Enterprises* (the "Foreign VC Regulations") and the 2005 *Provisional Regulations on Venture Capital Enterprises* (the "Domestic VC Regulations") jointly published by several PRC ministerial-level authorities, provide the most commonly-used legal framework for the private equity industry, together with the amended *Company Law of the People's Republic of China* (the "Company Law").

The China Banking Regulatory Commission, another PRC ministerial level authority, has also played a role in facilitating the creation and regulation of private equity funds. In early 2007, it issued the *Measures for the Administration of Trust Companies' Trust Plans of Raised Funds* and the complementary *Measures for the Administration for Trust Companies* (the "Trust Companies Measures"). The Trust Companies Measures, for the first time, authorized trust companies with the required license to raise funds from qualified investors and to make investments for the benefit of such qualified investors.

> *The implementation of the fragmented initiatives and regulations allows the Chinese government to accumulate necessary experience, which it will ultimately use to move toward the formation and enactment of a more comprehensive and higher-level legislation.*

In addition to these and other initiatives of various PRC ministerial-level authorities, several local governments are also eager to attract private equity investment into their areas by providing local administrative measures. Most noticeably, the Administration for Industry and Commerce of Tianjin Municipality, China's private equity experimental hub, quickly issued its own opinion on the registration of private equity funds in Tianjin in November 2007. To maintain its competitive edge and to promote Shanghai as the financial center of China, Shanghai recently adopted the "Industry Catalogue Mainly Supported in Shanghai," in which the private equity investment industry was listed as one of the types of investments supported and encouraged by Shanghai. Shanghai is also considering the offering of tax and other incentives to attract venture capital, private equity and hedge funds to Shanghai.

The fragmented initiatives and regulations create a puzzle for private equity firms and potential investors. Yet, it epitomizes China's legislative process for handling an economic issue in which the Chinese government does not have significant experience. The implementation of the fragmented initiatives and regulations allows the Chinese government to accumulate necessary experience, which it will ultimately use to move toward the formation and enactment of a more comprehensive and higher-level legislation. One such move came on June 1, 2007 when the *Partnership Law of the People's Republic of China*, as amended, became effective (the "Amended Partnership Law"). The Amended Partnership Law has eliminated several features from the previous Partnership Law that were particularly discouraging to private equity funds and instead provides several fundamental principles that are pillars to the establishment, management and operation of domestic RMB-denominated private equity funds in China. The adoption of this law was a great encouragement for the creation of private equity funds in China, evidenced by the fact that, less than one month after the Amended Partnership Law became effective, the first limited partnership private equity fund was formed.

Another such move is to make the domestic stock market more accessible and attractive to private equity funds and to encourage the country's best businesses to remain in China. In addition, China's tax regime has just undergone a major overhaul. On January 1, 2008, the *Enterprise Income Tax Law of the People's Republic of China* (the "EIT Law") and the *Detailed Rules for the Implementations of Enterprise Income Tax Law* (the "EIT Regulations") became effective. The impact of the EIT Law and EIT Regulations is certainly felt by the private equity world.

Though the above initiative and regulations are fragmented and complex, they provide some legal framework for the formation, management and operation of private equity funds. Indeed, approximately 200 private equity firms reportedly formed in China are organized under the Foreign VC Regulations, the Domestic VC Regulations and/or the Company Law, and a good number of private equity firms have also been formed under the Amended Partnership Law.

It is also important to note that, due to the developing nature of the private equity markets in China, private equity funds typically behave more like venture capital funds rather than traditional private equity funds. This is generally attributed to the size, type and nature of the available investments in China, which cause private equity and venture capital firms to consider deals that they generally would not consider outside of China. One of the effects of this situation is that, in China, the terms venture capital and private equity seem to be used interchangeably.

Historically, an interesting characteristic of the Chinese investment community is that a large number of individual investors and privately-owned companies are active, on-stage players, while pension funds, social security funds, and other such institutional investors stay on the sidelines. This is not surprising, given that pension, social security and the like are deposited with, and controlled and managed by, the government social security authority. There are signs that significant changes may be forthcoming that will make these funds available for investment. It is anticipated that RMB50 billion will be immediately available and that RMB100 billion will be available in three years. This source of funds will give RMB private equity industry a much needed boost. This authorization indicates that the Chinese government may also consider and evaluate allowing investment in RMB-denominated private equities by pension funds, social security funds, housing funds, and similar funds that are collected and managed by local social security bureaus across the nation and that, at present, are required to be deposited in state-controlled banks and to buy state treasury bonds. Given the short history of private equity industry in China, experienced fund managers are scarce. This may create opportunities for experienced international private equity industry players to play a role in China's growing private equity industry.

Aside from the development of the investment fund industry and legislation in China, in recent years, major international private equity firms have quickly formed funds targeting investment opportunities in China. Chinese capital has also flowed to offshore private equity funds, which then would find their way back into investments in China. Offshore private equity investments must follow the *Catalogue for the Guidance of Foreign Investment Industries, as amended* which classifies industries into categories in which foreign investment is encouraged, permitted, restricted or prohibited and that, in some cases, imposes a cap on foreign equity ownership. After two decades of welcoming and encouraging foreign capital, China is now beginning to scrutinize foreign investment. The amended *Regulations on the Acquisition of Domestic Enterprises by Foreign Investors* in 2006, and a series of foreign exchange control regulations enacted by the State Administration for Foreign Exchange, have created almost insurmountable obstacles to the offshore exit of private equity funds. The overhaul of the tax regime has also abolished the broad-based tax incentives that were previously available to companies in which offshore private equity funds invested.

Offshore private equity funds interested in investing in Chinese enterprises, and existing groups or funds with investments in China, need to take into consideration these on-going legal developments in China and carefully plan, structure, document and manage their projects.

Conclusion

China presents both abundant opportunities and frustrating challenges for private equity investment. With 25 percent of the world's population and one of its fastest growing economies, China enjoys noticeable success and is poised to create more global superstars. Success, however, is far from automatic. The success of private equity funds in China requires the right team in terms of capabilities and language and culture skills, an over-investment in due diligence to identify the full breath of risks and opportunities, a crystal-clear understanding of and commitment to the Chinese market, as well as a thorough appreciation of China's legal regime. Although China seems to be moving into the creation of a more stable and predictable legal system, private equity practice in China remains a challenging legal puzzle that requires knowledgeable and experienced legal counsel for guidance through this process.

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Protections for Participants in the Security Futures Market

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With the deepening and widening financial crisis, alternative investment funds have increasingly been confronted with the challenge of identifying ways within the current legal regime to protect their assets in accounts with brokers-dealers and future commission merchants ("FCMs"). This challenge is directly faced by hedge funds engaging in security futures transactions.

Futures Accounts vs. Securities Accounts

Security futures are allowed to be carried in either a securities account or in a futures account, or to be split between such accounts, with a fully registered FCM and broker-dealer ("FCM/BD"). One significant difference between a securities account and a futures account is that assets in a securities account are protected by the Securities Investor Protection Corporation ("SIPC") with a coverage limited to $500,000 per customer (including up to $100,000 for cash) while cash and security futures in a futures account are not covered by such insurance. For many security futures investors, the choice of account is likely to be driven in the first instance by the other types of assets that they hold and opportunities to cross-margin those assets with security futures. While the SIPC coverage cap might be determinative for individual investors, it will not likely be determinative for hedge funds.

Additionally, while a securities account also carries a reserve requirement intended to ensure that broker-dealers do not use customer funds to finance their own business or trading activities, the reserve requirement is calculated differently than is the segregation calculation required of FCMs (discussed below). And broker-dealers are required to make the reserve calculation and adjust the amount of the reserve on a weekly (in some cases, monthly) basis, as opposed to the daily basis for making segregation determinations required of FCMs.

The protection provided by the current legal regime for investors engaged in security futures transactions from a security futures account pivots on the requirement that FCMs segregate customer funds from their own funds. Moreover, FCMs are prohibited from using the funds of one customer to margin or guarantee the transactions of any other customers, although they are allowed to commingle customer funds used for trading on U.S. futures exchanges (but not with customer funds for other transactions). FCMs that carry customer funds are required to calculate their segregation requirements daily (as noted above) and add additional funds, if necessary, to cover customer debits and deficits. Laminating special provisions in the U.S. Bankruptcy Code and this segregation requirement result in a participant's funds being protected against insolvency losses provided those funds are properly segregated. The National Futures Association has stated that it believes that the segregation requirement, including the gross up and daily calculation requirement, provides a stronger protection and makes up for the lack of SIPC-like protection.

FCMs that carry customer funds are required to calculate their segregation requirements daily and add additional funds, if necessary, to cover customer debits and deficits.

Protection Strategies in a Futures Account

There is no current initiative to extend SIPC-like protection to futures accounts.

The protection provided by the current legal regime for investors engaged in security futures transactions from a security futures account pivots on the requirement that FCMs segregate customer funds from their own funds.

In the event an investor is, or becomes, worried about the financial stability of its FCM/BD it should consider certain strategies to alleviate its risks relating to potential insolvency of its FCM/BD.

1. *Withdrawal of all funds from its futures account or securities account to the extent not then required to cover open positions.* Under the security futures regime, a customer may withdraw cash, securities or other assets deposited as margin for positions in an account, provided that the equity in the account after such withdrawal is sufficient to satisfy the required margin for the security futures and related positions in the account under the rules of the Commodity Futures Trading Commission ("CFTC"). The margin requirements for security futures and related positions in one account may not be met by considering items in any other account, except that futures accounts of the same regulatory classification or account type owned by the same customer are allowed to be combined by the security futures intermediary for purposes of computing a customer's overall margin requirement.

Customers that use the alternative collateral valuation method for equity securities are subject to an additional restriction on withdrawals. Specifically, cash, securities or other assets may not be withdrawn with respect to an account that uses the alternative method if:

(i) additional cash, securities, or other assets are required to be deposited as margin for a transaction in the account on the same or a previous day, pursuant to a special margin requirement (which requires additional cash, securities or other assets be deposited on any day when the day's security futures transactions and related transactions would create or increase a margin deficiency in the account if the margin equity securities were valued at their Regulation T collateral value and should be for the amount of the margin deficiency so created or increased); or

(ii) the withdrawal, together with other transactions, deposits and withdrawals on the same day, would create or increase a margin deficiency if the margin equity securities were valued at their Regulation T collateral value.

This restriction is intended to prevent a customer from withdrawing margin deposited to satisfy a special margin requirement, unless the customer's equity exceeds the required margin in the account or the customer substitutes securities of equivalent value.

It should also be noted that the security futures intermediary (including an FCM) may deduct certain payments and charges from a customer account to meet the customer's obligations to the security futures intermediary and third parties. Such payment and charges include (i) variation settlement payable to a clearing agency or derivatives clearing organization; (ii) interest charged on credit maintained in the account; (iii) communication or shipping charges with respect to transactions in the account; (iv) payment of commissions, brokerage, taxes, storage and other charges; and (v) any service charges that the security futures intermediary may impose.

2. *Transfer assets from a futures account to a securities account, especially when the FCM/BD is calculating the reserve requirement for the securities account on a weekly basis.* Although the maximum amount

It should also be noted that the security futures intermediary (including an FCM) may deduct certain payments and charges from a customer account to meet the customer's obligations to the security futures intermediary and third parties.

Additional consideration should be given to the flexibility of the participant's security futures assets, such as the capability of cross-margin, when determining whether to transfer security futures and positions from a futures account to a securities account.

covered by SIPC in a securities account is significantly below typical investment amounts by an institutional investor, some broker-dealers provide additional coverage for customers' securities accounts with commercial insurance from either Customer Asset Protection Company ("CAPCO") with no limitations on the coverage, or Lloyd's of London with a coverage cap at a specific amount per customer account and a specific amount per broker-dealer. An investor may consider transferring its security futures, as well as the positions from a futures account to a securities account by taking into consideration the total coverage for a securities account and the different margin requirements between a futures account and a securities account.

However, transfer of security futures and positions from a futures account to a securities account is feasible only for customers of a FCM/BD which is registered with both CFTC (as an FCM) and Securities and Exchange Commission (as a broker-dealer) and is authorized to open both securities accounts and futures accounts for its customers' security futures transactions.

In addition, an FCM/BD is required to establish written policies or procedures for determining whether customer security futures products will be placed in a futures account and/or a securities account and, if applicable, the process by which a customer may elect the type or types of account in which security futures products will be held. Although under the current security futures regime, there is no express prohibition from transferring security futures and positions from a futures account to a securities account, such transfers may well be subject to restrictions and procedures established by the FCM.

Finally, as noted, additional consideration should be given to the flexibility of the participant's security futures assets, such as the capability of cross-margin, when determining whether to transfer security futures and positions from a futures account to a securities account.

This article only provides a brief discussion of the considerations relevant to designing a strategy to protect assets committed to security futures transactions. For more information regarding safeguarding assets committed to security futures trading, please feel free to contact us.

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Bailout Legislation Limits Income Deferral by Hedge Fund Managers

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The Emergency Economic Stabilization Act of 2008 includes a new provision, Section 457A of the Internal Revenue Code, intended to prevent hedge fund managers from using off-shore tax haven corporations and other structures to defer U.S. income tax on compensation received for providing investment services.

Previously, U.S. individuals could defer paying tax on compensation until paid, as long as the corporation paying the deferred compensation deferred its deduction. Matching the timing of the deduction with the income inclusion was designed to ensure that the individual could not achieve the tax benefits of deferred compensation at the expense of the Treasury. Where, however, payment was made by an offshore tax haven corporation or by a partnership, substantially all of the income of which was allocated to tax-exempt organizations or non-U.S. persons not subject to tax, the payor was indifferent as to the deduction.

As a result, in such situations, the matching of a deferral of deductions as a condition for deferring the recognition of taxable income to the U.S. individual had no meaningful tax consequences to the payor entity. Many hedge funds took advantage of this tax-planning opportunity and used structures whereby payment of management fees was deferred by tax indifferent payors.

Previously, U.S. individuals could defer paying tax on compensation until paid, as long as the corporation paying the deferred compensation deferred its deduction.

The new law requires certain deferred compensation owed by certain non-U.S. entities to be taken into income as it accrues, regardless of the timing of the payments, as long as the entitlement to the compensation is not subject to a "substantial risk of forfeiture" (*i.e.*, is not conditioned upon the future performance of substantial services or the possibility of forfeiture is not substantial). Any amounts owed but not currently ascertainable would be taken into income when ascertainable, subject to both an interest charge imposed on the related (deferred) tax liability, and an additional 20 percent tax. The rule covers deferred compensation paid by:

- any non-U.S. corporation, unless substantially all of its income is:

  a. effectively connected with a trade or business in the United States, or

  b. subject to a comprehensive non-U.S. income tax; and

- any partnership (U.S. or non-U.S.) unless substantially all of its income is allocated to persons other than:

  a. non-U.S. persons for whom that income is not subject to a comprehensive foreign income tax, and

  b. organizations that are exempt from U.S. income tax.

The new law contains an exception for payments that are received not later than 12 months after the end of the taxable year in which the right to compensation is no longer subject to a substantial risk of forfeiture.

Certain contingent compensation received from investment funds is

The new law requires certain deferred compensation owed by certain non-U.S. entities to be taken into income as it accrues, regardless of the timing of the payments, as long as the entitlement to the compensation is not subject to a "substantial risk of forfeiture."

excluded from the new rule. Specifically, if compensation is determined solely by reference to the amount of gain recognized on the disposition of an "investment asset," that compensation is treated as subject to a substantial risk of forfeiture until the date of the asset disposition. "Investment asset" is defined to mean any single asset (other than an investment fund or similar entity) that is:

- acquired directly by an investment fund or similar entity,
- with respect to which neither the entity nor any person related to the entity participates in the active management of that asset (or if that asset is an interest in an entity, in the active management of the activities of the entity), and
- substantially all of any gain on the disposition of that asset (other than the deferred compensation) is allocated to investors in the fund.

The new law generally is effective for deferred amounts attributable to services performed after December 31, 2008.

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NEWS ALERT FSA Statement on Market Abuse Controls Among Hedge Fund Managers

In October 2007, in its publication *Market Watch 24*, the U.K. Financial Services Authority ("FSA") set out its findings on the extent and appropriateness of market abuse controls among a cross-section of hedge fund managers. Expressing itself "disappointed by some of what we saw," the FSA committed itself to not merely follow up with the firms visited, but also to undertake further visits to a wider cross-section of hedge fund managers. A year later, the FSA has published the results of this additional initiative in *Market Watch 29*.

Although *Market Watch 24* does not make this point directly, it looks as if the results of its earlier survey had led the FSA to conclude that there might be a problem with the controls that hedge fund managers generally had in place to deal with market abuse, and as a result a wider survey was necessary to establish whether that was the position. However, if that were the rationale for the FSA's further initiative, the results conveyed in Market Watch 29 indicate that there is not a general problem among hedge fund managers in this area. As the FSA notes, "all firms appeared to have given reasonable consideration to market abuse issues," and all firms monitored trading activity and operated a personal account dealing policy. So the impression that *Market Watch 24* perhaps unwittingly gave — that this was a sector of the market where controls were particularly lax — has not been supported by the FSA's further work.

Nonetheless, there were a number of areas where the FSA identified aspects to which firms should pay particular attention and where improvements to existing procedures could be made:

- **compliance**: firms should ensure that, as far as possible, the compliance and executive functions should be kept separate (for instance, through the use of external compliance consultants);

- **control of inside information**: firms should limit the distribution of restricted lists to those individuals who need to know, and should have a process in place to determine what information is made available under non-disclosure agreements, so as to be better able to proactively monitor subsequent trading;

- **monitoring of trading activity**: firms should not rely simply on the fact that they operate in an open-plan environment, and/or have remuneration structures in place that are long-term in nature, as reasons for thinking that they have taken sufficient measures against the risks of market abuse. Instead, they should monitor trading activity generally, particularly around valuation dates and company announcements. The FSA suggests that, as many hedge fund managers are not large enough to justify the installation of sophisticated computer detection systems, they should maintain "reason for trading" records;

- **training**: it is not enough to rely simply on online training in relation to market abuse issues; there should be face-to-face training using case studies relevant to the firm's business;

- **personal account dealing**: firms should consider receiving copy contract notes to record and verify employee dealings; and

- **telephone taping**: firms should consider the need to introduce a mobile phone policy (this seems strange, as the relevant FSA rules coming into force in March 2009 expressly exclude mobile phones from their scope).

The FSA concludes its remarks by making the unexceptional point that market abuse controls should not be regarded as something that firms can "fit and forget"; they should regularly consider whether their existing procedures remain suitable to their businesses. But it is odd that the FSA should raise the short selling restriction introduced in September in this context and seemingly criticize firms for not anticipating such a change. Firms could surely be forgiven for failing to do so, particularly given that, less than 24 hours beforehand, the FSA chief executive was publicly stating that short selling had a legitimate role to play in the markets.

Although hedge fund managers have received a relatively clean bill of health from the FSA as regards their market abuse controls, *Market Watch 29* is no reason for complacency. Given the importance to the FSA of curbing market abuse, and the consequent risk of the FSA taking action against any firm it thinks has fallen short of the appropriate standards, firms should regularly review the effectiveness of their market abuse controls and make any necessary changes.

Firms that have signed up, or are considering signing up, to the standards overseen by the Hedge Fund Standards Board should note that these standards contain provisions regarding effective arrangements for the identification, detection and prevention of market abuse, as well as a requirement for hedge fund managers to disclose to investors that they have a policy to prevent market abuse (Standards 23 and 24). This is a clear sign that the industry, as well as the regulator, takes this matter seriously, and that firms will be falling short of industry best practice if they do not follow suit.

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