

# MFA Reporter

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Reporting on issues for investment professionals in futures,  
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## Required Reading: Advanced Due Diligence for Investors

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**F**raud and other “blow ups” are an unfortunate reality in the hedge fund industry, but proper due diligence can save investors from disastrous investments. Unfortunately, many investors do not take adequate precautions before investing their money, resulting in losses which could have been avoided with a bit of effort. The purpose of this article is to outline some basic due diligence procedures that can be followed by any investor in a hedge fund, as well as to guide fund managers as to what legal documents they should have in place.

### Documentary Due Diligence

#### What are the Mandatory Documents to Review?

Investors should treat each investment with the same level of legal due diligence that would be employed if the investor were involved in a mergers & acquisitions (M&A) transaction. Legal due diligence should begin when an investor receives a copy of a private placement memorandum (Memorandum). This document may indicate the overall level of professionalism of the fund and its manager and must be read in its entirety. Attention should be given to the service providers to be employed by the fund. The use of unknown or low-cost service providers may indicate a manager's disinterest in regulatory compliance in order to operate as cheaply as possible. Even worse, the lack of identification of any legal or accounting service providers

may indicate that the manager itself has cobbled together the fund documentation from various sources which may present a variety of problems.

An investor should verify that each service provider identified by the fund actually acts for the fund. It is not uncommon for investors to discover a service provider identified in the Memorandum has never heard of the fund or its manager.

Investors should also review the fund's audited financial statements for at least the most recent three years. Auditors are under heightened scrutiny due to the Sarbanes-Oxley Act of 2002, as amended. Any unusual notes or exceptions to generally accepted accounting principles (with the exception of the amortization of organizational and initial offering fees and

expenses) should be investigated further.

#### What Additional Documents Should Be Reviewed?

An investor should also ask for and review signed copies of all fund documents and ancillary agreements. In the event of a future problem with an investment, such documents will be much more difficult or impossible to obtain, making it more difficult to understand one's rights. If the manager is reluctant to provide any of the following documents, it may mean (i) that they don't exist or (ii) that they have not been signed, either of which is problematic.



*The most important agreement from a due diligence standpoint may be the fund's ISDA master agreements.*



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Constituent documents. A domestic fund's constituent documents include the limited liability company agreement or limited partnership agreement, certificate of formation or limited partnership, any necessary state qualifications and possibly a certificate of good standing showing all state filings have been timely made and paid. An offshore fund should provide its certificate of incorporation, memorandum and articles of association, by-laws, certificate of registration as a mutual fund, if applicable, and any undertakings exempting the fund from taxation in offshore tax haven jurisdictions. If a fund is listed on an exchange, an investor should also request a copy of the exchange order granting the listing. Furthermore, if the fund is part of a master-feeder structure, an investor should request signed copies of the master fund's constituent documents.

Service provider agreements. Such agreements include investment management agreements, trading adviser agreements, administrator agreements, prime brokerage agreements, master repurchase agreements, futures brokerage agreements, and any other material agreements.

The most important agreement from a due diligence standpoint may be the fund's ISDA master agreements. These highly-negotiable agreements provide the legal framework for many over-the-counter transactions such as swaps, interbank forward currency trading, credit derivatives, over-the-counter options and other transactions. An investor should understand what agreements he or she is buying into by investing in a fund which has ISDA master agreements in place. An investor should ask if they have been reviewed by the fund's legal counsel; if a fund has signed an onerous agreement without review by counsel, the fund manager may not be concerned with safeguarding investor assets. When reviewing ISDA master agreements, an investor should pay attention to the following issues:


- Does the fund under consideration have any "specified entities" or "affiliates"? If so, this may turn out to be problematic.

- What additional events of default or termination events exist and how could they affect the investment? If a hedge fund has specified entities listed in the Schedule to the ISDA master agreement, an event of default or termination event affecting the specified entities may be an event of default or termination event with respect to other funds managed by the same manager which also have ISDA master agreements in place, even if such other funds are otherwise completely financially healthy.
- How is payment on termination prior to the maturity date arising out of an event or default of an additional termination event determined? If the 1992 ISDA master

agreement is in place, the relatively neutral "Market Quotation" method of payment is preferable to the broader indemnity of "Loss."

In reviewing the above documents, an investor must make sure the Memorandum accurately summarizes the provisions of the underlying documents. For U.S. funds at least, in the event of any inconsistency, the operative

underlying documents will trump the Memorandum.



*When reviewing the track record of a fund, it is important to fully understand where profits and losses are generated.*

### Registrations and Exemptions

The area of registration and exemptions is one where an investor can make good use of publicly-available resources. Investors can access Part I of any investment adviser's Form ADV on-line at the Securities and Exchange Commission (SEC) Web site [www.adviserinfo.sec.gov/IAPD/Content/IapdMain/iapd\\_SiteMap.aspx](http://www.adviserinfo.sec.gov/IAPD/Content/IapdMain/iapd_SiteMap.aspx). Also, a registered investment adviser must provide investors with Part II of its Form ADV prior to soliciting an account. Additionally, an investor can access Commodity Futures Trading Commission (CFTC) registration information on the National Futures Association (NFA) Web site [www.nfa.futures.org](http://www.nfa.futures.org). Investors should ensure that all information is consistent and all persons identified from each source are the same.

Additionally, investors should confirm that all claims of exemption are properly filed and all parties are correctly claiming a proper exemption from registration. This is most



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applicable in funds that trade futures; the operator may (i) be registered as a commodity pool operator and have filed the Memorandum with the NFA, (ii) be exempt from so doing under CFTC Rule 4.7 or CFTC Advisory 18-96, or (iii) be exempt from commodity pool operator registration under CFTC Regulation 4.13(a)(3) or (4). An investor should telephone the NFA at 1.800.621.3570 to verify that the appropriate exemption has been properly claimed.

Also, regulators such as the SEC, NFA and CFTC disclose violations made by people and entities registered with them. Finally, one should not overlook securities administrators in the state where the adviser or its principals are or have been located. Lesser frauds often go undetected by Federal regulators and only get picked up at the state level.

Furthermore, an investor should request copies of the most recent three SEC and NFA audit reports as well as the manager's responses. Such audit reports will show the number and level of infractions which the SEC or other self-regulatory organization finds. A six-page SEC comment letter could be routine; a thirty-page letter may indicate deeper issues. Furthermore, investors should obtain copies of multiple audit reports to ensure that previously identified infractions have been remedied.

When reading these reports, an investor should differentiate minor and major infractions. In SEC audit reports, most advisers are likely to be cited for minor violations of Rule 204, likely due to technical record-keeping issues. However, violations of the anti-fraud rules under Section 206 of the Investment Advisers Act of 1940, as amended, may be significantly more serious. NFA audit reports tend to be shorter and less detailed than SEC reports but may indicate small or more serious problems.

### Track Records of Funds

Finally, an investor must carefully review a fund's track record before deciding to invest. An investor should understand the limitations inherent to hypothetical track records. For commodity pools, the NFA has restricted use of hypothetical performance to very limited circumstances.

Investors also should not rely on track records published in industry databases. Most publishers of performance statistic reports print such track records as received from the

fund or fund manager. The publishers are not obligated to, and often do not, conduct any verification of data. Investors must dig beneath the surface to see if the published numbers add up. To conduct such research, investors may need to consult the adviser's monthly brokerage statements.

Finally, when reviewing the track record of a fund, it is important to fully understand where profits and losses are generated. Almost all managers will have some constraints on the types of instruments traded as well as the amount of leverage employed. Investors should determine whether the manager is complying with the investment guidelines and trading strategies described. The manager's profits should derive from the instruments and sectors that the manager purports to be trading. It is especially important to discuss with the manager what developments and investments are behind the numbers for particularly good or bad months to determine if there are significant deviations from the stated strategies and guidelines to generate such results, or if leverage has been increased in an attempt to make up prior losses. Frequently, track records with anomalies which have been reviewed by the manager and its outside counsel may contain a footnote stating the reason certain results are omitted or adjustments have been made to take account of extraneous circumstances and/or fees and expenses. Such footnotes are material information, and it is vital for investors to understand what they mean.

In conclusion, conducting adequate due diligence is one of the most vital parts of the investment process. By taking the steps outlined above, an investor may be able to minimize the risk of making an investment with a manager. ■

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*Arnold & Porter LLP is a full-service international law firm with seven offices and approximately 650 attorneys specializing in providing a full-range of corporate transactional services to hedge funds, fund of funds, "plan assets funds," banks, brokers, investment advisers, commodity pool operators, commodity trading advisors and other financial market participants. In addition, the firm has an active hedge fund litigation practice. For more information about Arnold & Porter's hedge fund practice group, contact the authors. J.P. Bruynes is a partner in the Arnold & Porter LLP Hedge Funds Practice Group. He can be reached at 212.715.1135 or [jp\\_bruynes@aporter.com](mailto:jp_bruynes@aporter.com). William V. de Cordova is an associate in the Arnold & Porter LLP Hedge Funds Practice Group. He can be reached at 212.715.1020 or at [william\\_decordova@aporter.com](mailto:william_decordova@aporter.com).*

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