HFWG
Hedge Fund Working Group

October 2007

Hedge Fund Standards: Consultation Paper

PART 1: Approach to best practice in context

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Notes on Consultation

The Hedge Fund Working Group (the "HFWG")[1] decided at the outset that the process of creating best practice standards should include a period of public consultation. This document represents that step.

Members of the Group are keen to receive your feedback. The consultation questions are highlighted at the end of the relevant sections in italics and are also provided in a separate table (Appendix E), which we believe will help you to direct your comments. In addition we would welcome any other comments or observations on either or both of Parts 1 and 2 of this report. The best practice standards are highlighted in blue-shaded boxes in Part 2 of the report.

Responses to the consultation document should be addressed to:

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Please note that, unless you state to the contrary, responses will appear on the website in due course.

Finally we draw your attention to the fact that feedback is to be submitted by Friday, 14 December 2007. The final report will be available in January 2008.

If there is any further information you require, please refer to the website www.hfwg.co.uk.

1 The members of the group are shown in Appendix A.

How to read this report

The HFWG report consists of two parts:

- Part 1 addresses a general audience with an overall interest in the sector.
- Part 2 contains the actual best practice standards and addresses a professional audience. The standards are highlighted in bold within each section in blue-shaded boxes.

For those interested in a quick view of the approach taken in this report, and what it seeks to do, we suggest reading the Introduction and the Executive Summary in Part 1.

The remainder of Part 1 summarises the best practice standards which lie at the heart of this report, why these standards should be complied with, how the standards should evolve, and how this UK-based initiative fits into the global context.

Part 2 details the 15 standards of best practice drawn up by members of the HFWG, which cover a significant proportion of the issues that confront this rapidly growing industry.

Foreword

It is clear that the hedge fund sector has emerged as a major factor in the asset management arena. The sector's size and activity increasingly touch us all. And yet many charges are levelled at the sector. Some of them are well founded, others less so. But what is clear is that many of them have been too long left unanswered.

So what struck me when I was asked to chair this group of some of the leading hedge fund managers was that this report was needed. It has always seemed to me that areas of finance which are not well understood can benefit from articulating the ways that practitioners think about their business. That after all is what underlies all standards of best practice. And it is vital that such standards are put together by the people who carry on the business. They know how it works and they know the realities underlying the issues that are raised. So the fact that some of the most prominent members of the industry in the UK have led this initiative strikes me as hugely significant.

The reasons for undertaking the initiative are various. There is a wish to show the world that the sector acknowledges its responsibilities. Equally there is a wish to enhance the reputation of, and confidence in, the sector. Finally, there is considerable concern about the possibility of potentially poorly thought out regulation. All these can be described as enlightened self interest.

As to the issues that are raised in relation to the hedge fund sector, this report is designed to address them as a "first step" by creating standards of best practice which embody high standards of conduct that are of relevance to both hedge fund managers and all of the relevant stakeholders in the sector. This is only the "first step" and there will be a long road ahead for a number of reasons:

- First, we have not addressed all the issues. We have deliberately chosen those which seem to be of greatest significance in today's environment – hence an emphasis on financial stability issues. But as the hedge fund investor base changes towards institutional investors with duties towards their own retail investors, or even retail investors themselves, there will be further work to do on investor protection issues.
- Second, the demands of stakeholders on the one hand, and the processes used by the industry on the other, will evolve. The best practice standards of today will need to adapt to meet these changes.
- Third, there is clearly a global dimension to the sector. Best practice standards may well need to adapt to take account of that.

For these reasons the report examines how the future of the standards might be ensured.

As to the best practice standards themselves:

- First, disclosure is at the root of all our recommendations. Clarity as to what should be disclosed, to whom, and by what means is the best way of countering charges of a lack of transparency. It is also, in my view, the best way of ensuring that prescriptive rules are kept to a minimum. In turn, this avoids the need to attempt to create what would necessarily be a voluminous compendium if it were to cover the hugely diverse activities and types of organisations which make up the hedge fund world. This approach also avoids what would be the impractical tasks of creating the rules in the first place and of ensuring confidence that

they would be complied with. A further benefit of the "comply or explain", disclosure based approach described below will be that the standards to which a fund manager intends to adhere will be clear to investors.

- Second, although the standards are of course addressed to the hedge fund managers, there are, however, other parties who are involved in some or all of the activities of hedge funds. They include investment banks and, increasingly, the long-only world, whether represented by traditional asset managers, or sovereign wealth funds. We hope that the standards may serve as a basis for discussion where issues arise that affect some of these wider groups. Taking "activism", for example, there are issues which need to be resolved in a larger forum than the hedge fund sector alone. The approaches suggested in this report may serve as an ingredient in such debates.

- Third, the best practice standards are all approached in a similar fashion. The issue which each standard is designed to address is outlined, as is the party most affected by the outcome – in most cases the investor. We then show the intended outcome and how it will be achieved.

Given the timing of this paper, it would be odd to stay silent about the financial instability of recent months. I believe that if several years ago we had looked ahead to a financial crisis now it would have been likely that the hedge fund sector would have been seen as a probable central player in the crisis. It is worth remarking that in the present situation this has not been the case. Of course there have been some failures, and investors in such cases may nurse losses. It may have been the case too that some of the volatility which occurred at an early stage of the crisis could have originated in the hedge fund world. But, broadly speaking, and with the caveat that further events may alter this judgment, hedge funds do not seem to have been central to the systemic issues which have arisen. Instead these have centred on the process of disintermediation – and "remediation" – in the banking world.

However, there is clearly no cause for complacency. And indeed a number of important lessons have been learned, which we have been able to use as ingredients for several of the areas of best practice:

- First, we have stressed risk management processes in general, and within these the vital importance of liquidity risk management. This is the process of ensuring that hedge funds always have sufficient cash to meet their obligations, whether in relation to meeting redemption requests from investors, or increased margin calls from lenders or trading counterparties or to managing the possibility of credit being withdrawn.

- Second, we have focussed on the handling of valuation of complex instruments or other instruments for which an ongoing fair value approach presents practical problems. It seems important that hedge funds and their investors reflect on the fact that there is no ideal solution here. No single set of numbers, however devised, can guarantee that a particular asset can be sold at or close to its valuation. What is important, though, is that the basis of such valuations is clearly explained so that they can be evaluated.

Finally, a word about the other main stakeholders in the hedge fund world, namely investors, prime brokers/lenders and supervisors. It has been pointed out elsewhere, and notably by the President's Working Group in the US, that particularly in areas of financial stability all these parties

need to play a role if the system is to remain sound. Important work has already been undertaken in the public sector and in the area of counterparties, lenders and prime brokers. Funds of funds already do exercise discipline. However, we would also encourage other major investors, particularly those with fiduciary responsibilities, to play a more forceful role.

It will be clear to the reader of this report, however, that most of the best practice standards are designed with the investor in mind. The importance of investors in relation to the best practices arises in two different senses:

- First, compliance with voluntary standards requires market processes to gain momentum. On the one hand, there is likely to be peer group pressure to comply. On the other, an equally strong determinant of compliance will be the demands of the investors.
- Second, following on from this, our document is a consultation paper. It represents the best that can be done by the managers themselves. Comments from investors, just as from other stakeholders, will be important to ensure that we reflect their needs.

The report is the product of a huge amount of work during a difficult summer. I think the difficulties have helped to sharpen its findings and recommendations. It is designed to be readable with Part I having a more general audience in mind and Part II being aimed more at the professional. I know I speak for all who have been involved in saying that we hope it will help to foster essential understanding of the sector and that we look forward to your comments.

Sir Andrew Large
Chairman of the Hedge Fund Working Group
October 2007

1. Executive summary

1. This exercise is a preliminary step towards establishing standards of best practice for hedge fund managers in some of the critical areas of their business. Standards of best practice are of increasing importance to hedge funds themselves and stakeholders such as investors, regulators and the wider public. The exercise is the initiative of 14 hedge fund managers which formed the ad hoc core working group and recognise that the considerable and growing influence of hedge funds implies commensurate responsibilities. We invite comments from all parties such as other hedge funds, investors, lenders, regulators, academic specialists and the public.

2. We recognise that bodies such Alternative Investment Management Association ("AIMA"), Managed Funds Association ("MFA") and the Chartered Financial Analyst Institute ("CFA Institute")[2] have done valuable work on the issues surrounding market practices for hedge funds and their managers. This document, however, aims to stimulate discussion leading to a consensus on a broad range of best practices for the industry. Although the initiative has been taken in the UK, we believe that the recommendations should have global relevance. The best practice standards have been compiled against the background of, and attempt to articulate how hedge fund managers might operate in order to live up to, the UK Financial Service Authority's ("FSA's") 11 Principles. The Principles are based on "common sense" and therefore have appeal beyond the UK.

3. Behind our initiative lie two broad concerns: how hedge funds affect financial stability and how hedge fund managers and investors in hedge funds relate to one another. These issues summarise several commonly voiced questions: What do hedge funds do? Why is transparency sometimes lacking and data hard to come by? What is the role of the sector in the wider economy? How are hedge funds regulated? Do hedge funds follow high-risk investment strategies? Do they have too much power and too little accountability? Are hedge funds the unacceptable face of corporate activism?

4. The practical proposals in this document start from the premise that the best way of addressing such questions is by establishing agreed and publicly recognised standards of best practice. The standards have been formulated in light of the spirit of the FSA's 11 Principles and seek to describe behaviour in relation to hedge funds which would be consistent with these Principles. The standards are designed to be adopted on a "comply or explain" basis. We have identified and particularly emphasised two overarching themes – governance and disclosure – which are relevant to all the best practices outlined. Beneath these two themes are 15 specific issues in relation to which we consider that the establishment of best practice will be particularly beneficial. We treat these issues consistently, in each case identifying the reason for selecting the issue, what we are trying to achieve (and for which stakeholders), the relevant FSA Principle and the new elements of best practice.

5. **Best practice standards.** Chapter 3 of Part 1 of this Paper contains a synopsis of the key issues which our best practice proposals cover. The chapter also has a table of the main best practice proposals. Full details of the issues and our proposals are in Part 2 of this Paper.

   In Part 2 we have grouped the 15 issues under five headings: disclosure to investors and counterparties; valuation; prudential and risk issues; fund governance and activism. Governance is a thread running through all five.

2 Which administers the Global Investment Performance Standards ("GIPS").

6. **Conformity with the standards.** Conformity with the best practice standards can be achieved either by complying or by offering a reasonable explanation as to why an exception is warranted. The explanation needs to be acceptable to the stakeholder for whom the standard was created. Although the standards are voluntary, we explain in our report why factors such as peer group and market pressure are likely to encourage adherence to them. A statement about conformity with the standards would be expected to be posted on a firm's website.

7. **Sector information.** Lack of reliable knowledge about some hedge funds has strongly influenced perceptions of them. There are two connected areas: publicly available generic data; and information about individual funds.

   A. *The sector.* Commonly raised questions include: What is the size of the industry, for example assets under management? What is the industry's economic impact, for example the number of people employed? Who are the investors, in general terms? What investment strategies are used? How does the industry's performance compare with other asset management sectors? How big are hedge funds' trading volumes? We recognise that there are significant difficulties of categorisation and comparison, and that databases already exist. Members of our group have therefore undertaken to collaborate with AIMA to develop a methodology for collating industry data in order to make more information about the hedge fund industry publicly available. For the moment, this database will be confined to the UK, but it will be a useful start and we expect that other publicly available data will be created in other jurisdictions.

   B. *Information on individual firms.* This is clearly sensitive. But our members feel that firms do have greater scope for disseminating information than they have perhaps realised. Websites are a valuable medium for doing this. Firms should have suitable websites, carrying an appropriate amount of information about themselves.

8. **The longer term.** The best practice standards in this report are a first step. If they are to be adopted widely and command confidence, they will need to evolve to respond to changes in the industry and the wider environment. A process for managing that evolution is required. We recommend that ownership of the standards be vested in a Board of Trustees. The HFWG would publish the mandate for the trustees, who would be guardians of the standards. They would not be regulators. The mandate would charge the trustees with ensuring that the standards remain suitable over time, that any gaps are filled, and that global issues are taken into account.

   As this process gathers momentum, we expect that some of the standards could converge on a more global basis to create a more widely shared set of best practices befitting a global industry. The mandate of the trustees would include working towards this end.

9. **Global Context.** Our report has global relevance in a minimum of two ways: the evolution of the UK standards and financial stability.

   UK-based hedge funds account for about 20% of funds managed by hedge funds globally, the majority of such funds outside the US. We decided to launch our initiative by anchoring the best practice standards in one regulatory regime, that of the FSA, to which firms have a legal obligation to adhere. The FSA's Principles are also based on widely-held tenets of good

business, so they may well be of value in other jurisdictions. There are good reasons to expect that best practice standards will converge globally, particularly in crucial areas such as risk management. This report therefore meshes with the initiative taken in September 2007 by the President's Working Group in the US to set up an Asset Managers' Committee. Cooperation with this initiative and discussions with other bodies such as the Financial Stability Forum and International Organization of Securities Commissions ("IOSCO") will be important for evolution of the standards.

Financial stability is a primary concern of supervisors and is of broad public interest. Concentration of risk is a particular issue, partly because of the difficulty of obtaining reliable information about investment positions and the extent and location of exposures. An important way of reducing supervisors' dependency on information about investment positions is to satisfy them that firms have a risk management framework which follows best practice standards, for example in the critical areas of liquidity management and stress testing and scenario planning. Hedge funds do not seem to have posed financial stability questions during the recent difficult credit conditions. But the HFWG welcomes close collaboration with supervisors on financial stability in the UK and elsewhere, reflecting hedge funds' acceptance of their responsibilities and willingness to play their part in ensuring the efficient and stable working of the financial system.

2. Overall introduction

2.1. Why are we publishing this report?

The hedge fund industry continues to grow in importance to financial markets globally. The variety of investors in the sector has widened significantly. The industry's activities in equity markets have become of major significance to company boards and management just as they are to government debt agencies in relation to debt, and to supervisors in relation to financial stability.

It is natural that people whose lives are, or could be, affected by any new area of activity are interested in understanding some of the more rudimentary questions about that activity. What do the participants do? How does the business work? How big is the sector?

Leading hedge fund managers recognise that their own investors and the public are increasingly interested in their activities and that with their growth in importance and influence come responsibilities. They are also aware that providing simple answers to the questions is not easy, and that the understanding of the sector, and how it operates and behaves, is not as great as it could be. Hedge fund managers are also conscious that concerns have been expressed about practices in the sector and recognise that there are areas where these could be improved.

This report, therefore, aims to help answer questions people might have about hedge funds, improve understanding of the sector, and make recommendations for improvements. Concerns inevitably arise if a powerful part of the economy is not understood, and the HFWG's objective is that this report will contribute to enhancing the confidence and respect with which the sector is held, so that both its merits and problems can be given the weight they deserve.

2.2. Issues covered in the report

Many of the observations made or questions raised about the sector are general and subjective. So rather than enter into what can become almost a political debate, we have focussed our work on a number of specific and objective aspects of hedge funds which we judge are of real significance. Increased understanding of how the industry addresses these aspects should also help to provide answers to some of the more generic questions. The reader will be able to see that hedge fund managers recognise the significance of each of these aspects, that they are addressing them, and in what way. We believe this should be conducive to improving confidence in the sector. By addressing the general question of transparency and disclosure, we also show how people can know that the improvements are being made.

2.3. The hedge fund sector: Introductory comments

The main thrust of this report is to develop effective best practice standards to address a number of specific issues. Before turning to these, however, a few comments on the hedge fund sector and some common observations about it are pertinent.

"Lack of clarity about what hedge funds are or do." Much has been written on this subject[3], but there is no legal or regulatory definition of a hedge fund in the UK. One useful way to understand hedge funds is to compare them with a classic (long-only) fund.

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3 For example, by the FSA (see Discussion Paper 16: Hedge Funds and the FSA) and by trade associations, such as the Alternative Investment Management Association (AIMA) (see www.aima.org) and the Managed Funds Association (MFA) (see www.mfa.org, FAQ section).

Defining features of hedge funds [4]

Hedge funds typically...	Traditional products typically...
• Invest both long and short	• Invest long only
• Are leveraged	• Not leveraged
• Have a high, performance-based fee structure	• Have a lower, ad valorem fee structure
• Normally require co-investment by fund manager	• Do not encourage co-investment
• Are able to use futures and other derivatives	• Are restricted in using derivatives
• Have a broad investment universe	• Often have a limited investment universe
• Can have large cash allocations	• Are required to stay fully invested
• Have an absolute return objective	• Have a relative return objective
• Investor access regulated, but the product itself is lightly regulated	• Are frequently heavily regulated

Appendix C (The Hedge Fund sector: History and present context) examines the historical development of the hedge fund sector in greater depth.

"Lack of transparency and data." The sector has grown extremely rapidly. There is accordingly no standardised data, and little consolidated publicly available data, about the industry. The criticism is not without foundation, and the issue has been a source of frustration to many: the report accordingly addresses this question in Chapter 5 *(Sector Information)*.

"Not enough regulation." Despite comments suggesting otherwise, all UK-based hedge fund managers are regulated in the UK. They are therefore required to comply with the FSA's 11 Principles[5] and the rules and guidance contained in its Handbook. Broadly speaking, these principles, rules and guidance apply to all regulated activities undertaken in the UK or abroad by FSA regulated hedge fund managers. Furthermore, to the extent that regulated hedge fund managers delegate any regulated activities to third parties, they remain responsible to their customers for compliance with these principles, rules and guidance with respect to the performance of such activities.

The UK is distinct from many other jurisdictions, including the US where regulation of the sector is less embracing and lacks such a set of statutory principles. Our document therefore directly embraces those principles in constructing our best practice standards.

"Too much risk." Compared to traditional fund management strategies, some hedge fund strategies employ higher levels of risk and in a small number of cases failures have resulted. That is why it is imperative that investors are able to make well informed judgments as to the nature of the strategies undertaken, and the degree of risk to which they will be exposed. At the same time, many hedge fund strategies are arguably less risky and less volatile than "long-only" investment in familiar instruments such as debt securities and equities.

4 Oliver Wyman: Perspectives on Asset Management – Hedge Funds, growth sector or maturing industry? (06/2005).
5 See Appendix B (FSA Principles).

"Too much power; too little accountability". Hedge funds and their managers are often considered to be too powerful or insufficiently accountable. Increasingly, however, hedge fund managers acknowledge that power and accept the responsibilities commensurate with it. This central fact underlies the substance of our report. In addition, hedge fund managers are required to comply with, among other things, the FSA's Principles, and this report outlines what the HFWG considers to be the best practice approach to complying with them, taking into account the realities of the sector.

"Too much corporate activism." Hedge funds are seen as short-term activists in their relations with companies in which they have an interest. Naturally, there are activist hedge funds, just as there are entrepreneurs, investment banks, and traditional asset managers in the same space. However, with approximately $50 billion of assets under management, activist hedge funds only constitute 3.3% of total global hedge fund assets, a small portion of the overall sector.[6,7] This compares with a private equity buyout volume (public-to-private) of $120 billion (in the US), £5.8 billion (in UK) and €25.7 billion (in continental Europe) in 2006 alone.[8]

Debate about activism in general is outside the scope of this report. But it is noteworthy that in recent years arguably complacent corporate managements have provoked commentators and politicians alike to call for shareholders to assert their voting power more. In the report, we make some proposals about activism which address specific concerns of relevance to hedge funds.

"Distinction between private equity and hedge funds." There is frequent confusion in the media and elsewhere between hedge funds and private equity firms. The two are very different. The British Private Equity and Venture Capital Association ("BVCA") defines private equity as "medium- to long-term finance provided in return for an equity stake in potentially high growth unquoted companies"[9]. This usually involves a combination of provision of capital and expertise from private equity executives. Hedge funds involve a form of direct asset management of portfolios of a wide variety of mainly financial assets. They do not seek to buy out firms that are publicly quoted, nor take responsibility for managing them. That said, there are areas of overlap and indeed a few hedge fund strategies approach those of private equity.

General answers to general questions of this sort are unlikely to alter attitudes on their own, or to achieve the objectives of this report. That is why we seek to address a number of specific issues which are directly relevant to the hedge fund sector.

2.4. Best practice standards

For the reasons given, we have identified what we believe to be the most significant areas of concern, as voiced by supervisors and others, which can be addressed by the development of standards of best practice. We have set out what these standards should be, together with what they are designed to achieve. And as to compliance with them, although there can be no guarantee, we explain why we believe that they will be adhered to.

Furthermore, we have identified a longer-term process for "taking ownership" of the standards themselves, so that they can be modified and further improved to ensure that gaps can be filled. Chapter 6 *(Longer term and next steps)* expands on our proposals.

6 The OECD estimates activist assets under management at approximately $50 billion: The Role of Private Pools of Capital in Corporate Governance: Summary and Main Findings (05/2007) p. 3, http://www.oecd.org/dataoecd/47/27/38672168.pdf

7 Total hedge fund assets are estimated at $1,500 billion by International Financial Services London: Hedge Funds City Business series, http://www.ifsl.org.uk/uploads/CBS_Hedge_Funds_2007.pdf. Note: Hedge Fund Net estimates $2,593 billion of total assets under management (Q2/2007).

8 Source: OECD: The Role of Private Pools of Capital in Corporate Governance: Summary and Main Findings (05/2007) p. 2, http://www.oecd.org/dataoecd/47/27/38672168.pdf

9 Further details can be found at the BVCA website: A guide to Private Equity, http://www.bvca.co.uk/publications/guide/intro.html

Overview of issues

The issues we identified and for which we propose best practice standards cover a wide range.

Area of concern		Issue
Disclosure	Investment policy	• Do hedge fund managers describe their investment policies and associated risks with the investments in sufficient detail?
	Commercial policy	• Do hedge fund managers provide adequate disclosure to investors about the commercial terms applicable to an investment in their funds?
	Performance measurement	• Do hedge fund managers sufficiently disclose the robustness of their performance calculation?
	Disclosure to lenders	• Do hedge fund managers provide lenders with sufficient information to assess risk adequately?
Valuation	Separation of duties	• Do hedge fund managers adequately mitigate potential conflicts of interest and provide investors wih sufficient information about the valuation process?
	Illiquid assets	• Do hedge fund managers adequately manage challenges arising in valuing assets (including complex derivatives) where reliable market data is not available?
Risk	Risk framework	• Do hedge fund managers adequately explain their approach to risk management and have a consistent framework in place?
	Portfolio risk	• In light of recent hedge fund failures, do hedge funds adequately monitor portfolio risks to ensure alignment with stated risk appetite and liquidity profile?
	Operational risk	• Do hedge funds ensure adequate management of operational risks (eg stemming from process and system related failures, improper market conduct)?
	Third party services	• Do hedge fund managers take sufficient care and conduct adequate due diligence when selecting third party service providers for the fund and continuously monitor them?
Fund Governance		• Do hedge fund managers provide a satisfactory mechanism or vehicle to handle potential conflicts of interest as between themselves and investors?
Activism	Market abuse	• Do hedge fund managers comply with applicable law and regulation on market abuse?
	Shareholder conduct: Proxy voting	• Hedge fund managers have become significant participants in equity markets, but do they fulfil their duty to vote proxies where it is in the best interests of investors?
	Shareholder conduct: Disclosure of derivative positions	• Do hedge fund managers use derivatives to avoid disclosure of (economic) positions in companies, which, if they owned the stock directly, would have to be made public?
	Shareholder conduct: Borrowed stock	• Is it appropriate for hedge funds to borrow stock to vote while not being economically exposed?

Consultation question

- *Are there further issues that the HFWG should address*?

The choice of issues has been determined by a number of factors, including their importance to particular concerns highlighted by the Financial Stability Forum, "to enhance existing sound practice benchmarks, in the areas of risk management, valuations and disclosure".[10] We have also included issues relating to market integrity and investors. The treatment of investor-related issues will no doubt increase as investor protection for less sophisticated investors becomes more relevant. Although the preponderance of investors in hedge funds are sophisticated at present, the balance is changing. And with the advent of new structures of mutual funds allowed Europe-wide under the UCITS[11] regulations, the increasing number of listed or quoted hedge fund vehicles, and the likelihood of increasing investment interest of institutions which ultimately have responsibilities towards retail investors (such as pension funds and insurance companies), this area will become more important and merit more attention in future.

It is important to note that the standards set out in this report strongly rely on disclosure rather than more prescriptive description of behaviour and practices. This leaves sufficient freedom for innovation and helps to avoid putting up undue hurdles for smaller hedge fund managers or new market entrants, who may not be able to comply with a detailed and prescriptive set of operational guidelines.

2.5. Approach to issues for which best practice standards are proposed

In the interests of consistency, a common "template" approach has been developed for each of the relevant issues. It covers the following:

- **Statement of the issue.** This identifies the issue where best practice is felt to be needed, with an introduction of why it is important.
- **Key stakeholders and desired outcome.** We state for which stakeholders the issue is important, and the outcome that best practice is designed to achieve (for example to "enable investors to be treated fairly, and make well-informed investment decisions"). In the case of the majority of the issues, the key stakeholder is the investor.
- **Relevant FSA Principles.** This identifies the relevant FSA Principle(s) in light of which the best practice standards have been be constructed.
- **Best practice standards.** We set out the actions that the HFWG believes hedge fund managers should take if they are to comply with the relevant FSA Principles in form and spirit. The HFWG members are committed to complying with these best practice standards, which are shown in bold type. For certain of the best practice standards, the report also contains guidance on how to comply with, or simply further information about, such best practice standards.
  - The question of how to comply with best practice raises important issues such as the governance and organisational arrangements needed to deal with each area of best practice identified, areas where potential conflicts of interest can arise and requirements for expertise and resources.

10 Financial Stability Forum: Update of the FSF Report on Highly Leveraged Financial Institutions (19 May 2007), p.7, http://www.fsforum.org/publications/HLI_Update-finalwithoutembargo19May07.pdf

11 UCITS: Undertakings for Collective Investment in Transferable Securities, eg unit trusts, common funds and SICAVs (Société d'Investissement à Capital Variable), http://europa.eu/scadplus/leg/en/lvb/l24036d.htm

– In addition, the best practice standards deal with the role of disclosure – and of what to whom. Disclosure is important as a tool of best practice because it allows relevant stakeholders easily to identify whether and how a best practice standard has been complied with and, to the extent that the standards require disclosure rather than prescribing how funds should run their businesses through rules and operational guidelines, caters for the broad variety of approaches hedge fund managers may take to managing their businesses.

- **Outsourcing**. We have some comments on outsourcing to third parties. This is about the role of third parties involved in ensuring that the desired best practice outcome is achieved. This issue is important given the essentially outsourcing intensive model most hedge funds and hedge fund managers adopt and the reliance many hedge fund managers place on such third parties providing sufficiently high quality services to enable them and hedge fund investors to have confidence that best practice will be complied with.

- **Links to existing standards**. Best practice standards cross refer to best practice materials produced by others such as AIMA and IOSCO, where the HFWG believes that they can help. Modification of those materials may be necessary in future if improvement is needed. Our aim here is to build on existing excellent work and avoid reinventing too many wheels.

2.6. Compliance and the way forward

There would be little purpose to this report unless it answers two vital and interrelated questions. First, will its best practice standards be complied with? And second, what is the future commitment to the standards?

The report explains and outlines factors which it is hoped will encourage managers to comply with these voluntary and industry-based standards. Chapter 4 *(Conformity with the standards)* addresses this question. It also outlines the requirement that where managers choose not to comply, the reasons for non-compliance (and they could be good reasons) are explained.

Securing the long-term future of the standards is equally important for their credibility. The HFWG has been an *ad hoc* group, put together as a first step to inject necessary energy and purpose into improving standards and transparency. This report is the outcome. It is, however, essential that there is a credible "owner" of these standards to ensure that the standards and practices remain relevant and adapt in response to inevitable changes in the environment, and that work is done to fill gaps identified now or in the future. A proposal is made for meeting this requirement in Chapter 6 *(Longer term and next steps)*.

The final chapter is about why this report originates in the UK. Given the new ground that we have attempted to cover and the complexity of obtaining consensus from a wide range of different participants, we have deliberately anchored the report in the UK. The UK has one regulatory regime and managers authorised in the UK are already required to comply with the FSA's Principles. These principles provide a powerful set of behavioural determinants at the outset, about which there is no argument. Moreover, UK managers are responsible for some 20% of global hedge fund activity, and are much the largest group outside the US. A large proportion of hedge fund activity outside the US is therefore covered by our proposals. The nature of the UK

regulatory regime and the size of the industry in the UK are the main reasons for our group being based in the UK. Chapter 7 *(The report in a global context)*, deals with all this in greater depth.

Nevertheless, if our proposals are to be taken forward globally, it is important that there be wide consultations on the impact of the recommendations and the applicability of the guidelines to other jurisdictions. We therefore hope that our work will be of value to managers in other jurisdictions. For example, we welcome the initiative of the President's Working Group in September 2007 to establish an Asset Managers' Committee to look at issues of risk management in connection with financial stability.

And, thirdly, it is clear that the hedge fund industry is global. For this reason, and particularly in light of a global common interest in financial stability, there would be every reason for certain standards to converge over time. The fact that our starting point is anchored in the UK should be seen as a useful device to kick-start a significant element of what needs to be a global process. We intend, therefore, to insert in the mandate to be given to the future "owners" of the standards a requirement to take into account the need for our standards and processes to respond to the global dimension. Evolution of the standards would thus reflect changes to the global environment while remaining valid for the UK.

We expect that close cooperation with agencies which have a global role, such as Financial Stability Forum and IOSCO, and with the equivalent industry groupings in other jurisdictions, notably the US, will facilitate evolution of the standards.

2.7. Regulatory status

As discussed, our report sets out what the members of the group believe to be best practice standards for hedge fund managers in light of the FSA Principles applicable to FSA authorised managers.

Hedge funds are often referred to by the media as an unregulated industry. This is not the case in the UK where any hedge fund manager engaged in investment management activity must be authorised and therefore regulated by the FSA. This requires being considered by the regulator as fit and proper to conduct investment business and involves an obligation to comply with the FSA's Principles, rules and guidance. All hedge fund managers operating in the UK are covered by this regulatory regime whether they are managing money for UK investors or for investors based overseas.

In other words, all hedge fund managers in the UK are regulated. Even though the funds themselves are often based offshore in foreign jurisdictions such as the Cayman Islands or British Virgin Islands and are not regulated by the FSA, a UK-based manager is still under an obligation to comply with the FSA's Principles in respect of any offshore fund which it manages.

Whilst the group has been in contact with the FSA during the development of the report, the FSA has not reviewed or approved this document and has not indicated that it will take any of its contents into account when exercising its regulatory functions.

3. Best practice standards

This section provides a high level overview on the best practice standards delineated in Part 2 of the report. The best practices address the 15 issues that the HFWG has identified.

3.1. Disclosure to investors and counterparties

Investors need a significant amount of information to make well-founded investment decisions. This includes information on investment and commercial policies. In addition, investors require ongoing information about performance and changes to investment and commercial policies.

Counterparties such as lenders likewise require information, which hedge fund managers need to agree to make available. In addition, it is necessary to address conflicts of interest which can arise between counterparties and funds.

Area of concern	Issue	Overview of best practice standards
Investment policy disclosure	Do managers describe their investment policies and risks associated with the investments in sufficient detail?	• Managers should ensure appropriate level of disclosure and explanation in the funds' offering documents about its investment policy and associated risks so that investors can make well-informed investment decisions
Commercial terms disclosure	Do managers provide adequate disclosure to investors about the commercial terms applicable to an investment in their funds?	• Managers should ensure that the commercial terms (fees, lock-ups, etc) of a fund are disclosed with sufficient detail and prominence in the fund's marketing materials • Side letters conferring preferential terms should be disclosed
Performance measurement	Do hedge fund managers sufficiently disclose the robustness of their performance calculation?	• Reference should be made to factors affecting the robustness of the performance calculation, such as significant illiquid assets
Disclosure to lenders/prime brokers/dealers	Do hedge fund managers provide lenders with sufficient information to assess risk adequately?	• Managers should provide their counterparties with sufficient information to assess risk

3.2. Valuation

The nature of hedge fund investment strategies and the assets in which they invest can raise questions about determining the value of a fund's portfolio at any given time. Valuation of assets, of course, has been important during the recent difficulties in the credit markets. There are two critical issues about valuation in general: segregation of the valuation and portfolio management functions; and how to deal with difficult-to-value assets.

The proposed best practice standards seek to ensure that managers have robust governance to mitigate potential conflicts of interest and provide investors with sufficient information about the nature and thoroughness of the valuation process.

Area of concern	Issue	Overview of best practice standards
Segregation of the valuation and portfolio management functions	Do managers adequately mitigate potential conflicts of interest and provide investors with sufficient information about the valuation process?	• Managers should arrange for the fund to appoint an independent third party valuation agent and/or operate a segregated in-house valuation function • Managers should disclose their approach to valuation (eg processes, controls, manager involvement) to investors upon request
Difficult-to-value assets	Do hedge fund managers adequately manage challenges arising in valuing assets (including complex derivatives) where reliable market data is not available?	• Managers should have appropriate procedures for valuing difficult-to-value (illiquid) assets to ensure consistency and dependability • Specific governance mechanisms and well defined procedures are required for the following activities: – Reliance on "broker quotes" – Use of "side pockets" – Use of "pricing models" • Managers should disclose the extent to which pricing models are used and the proportion of assets that is hard to value

3.3. Prudential and risk issues

Risk is the essence of the hedge fund business. The risks that managers take can affect a wide variety of stakeholders, including investors, prime brokers and the managers themselves, and are significant for financial stability. Key aspects that managers need to address in this context are the risk management framework and risk management approaches relating to the areas of portfolio risk, operational risk and outsourcing risk.

The proposed best practice standards seek to ensure that managers understand the risks arising from their activities and have a responsible approach to managing them.

Area of concern	Issue	Overview of best practice standards
Risk framework	Do hedge fund managers adequately explain their approach to risk management and have a consistent framework in place?	• Managers should think about risk in the context of a "framework" and explain it to their investors in the offering documents
Portfolio risk management	Do hedge funds adequately monitor portfolio risks to ensure alignment with stated risk appetite and liquidity profile?	• Managers should employ a broad range of risk measurement techniques to assess market liquidity and counterparty credit risks. Particular focus should be on "unexpected" events or stresses, taking into account the links between market and liquidity risk and valuation sensitivities in stress situations
Operational risk	Do hedge funds ensure adequate management of operational risks (eg stemming from process and system related failures or improper market conduct)?	• Managers should put in place adequate governance mechanisms and well defined procedures to prevent breakdowns of internal controls or systems. This relates to areas such as trading and execution, fraud and financial crime prevention, disaster recovery and IT security • Managers should provide comfort to investors and creditors by disclosing a summary of operational risk management procedures and controls to investors and creditors undertaking due diligence
Outsourcing risk	Do hedge fund managers take sufficient care and conduct adequate due diligence when selecting third party service providers for the fund and continuously monitor them?	• Managers should conduct careful due diligence into third party service providers before recommending them to the relevant fund governing body • Managers should disclose use of third party service providers and the nature of these relationships to investors undertaking due diligence reviews

3.4. Fund governance

Potential conflicts of interest can arise between hedge fund managers, the hedge funds which they manage and investors in those hedge funds. These potential conflicts can include manager remuneration and other related factors and the need to ensure fair treatment of multiple clients.

The proposed best practice standards seek to mitigate these conflicts of interest by requiring adequate governance mechanisms and oversight. The HFWG acknowledges that there is a spectrum of different kinds of governance approaches, determined by the nature of the investor base. At one end of the spectrum are more informal types of hedge funds, where the managers themselves are significant investors and know the other, sophisticated, investors. At the other end, for example with listed or quoted vehicles, the fund is likely to have more formal governance arrangements.

Area of concern	Issue	Overview of best practice standards
Fund governance	Do managers provide a satisfactory mechanism or vehicle to handle potential conflicts of interest as between themselves and investors?	• Managers should assess where the fund governance structure should lie on the spectrum (see above) and make sufficient resources available to identify and obtain members of fund governing bodies with sufficient experience • Managers should advise fund governing bodies on the suitability of the governance processes throughout the life of the fund

3.5. Activism

Investors who are especially engaged in the affairs of the companies in which they invest are often called "activist". Although activism is by no means unique to hedge funds, the HFWG recognises that there is a public debate on the advantages and disadvantages of activist investing.

The proposed best practice standards seek to ensure good investor behaviour with respect to prevention of market abuse and shareholder conduct.

We would like to see the adoption of a set of standards which are a benchmark for investor behaviour. Such standards would include disclosure of economic interest in a company through derivatives, making it best practice to vote proxies but not to vote on borrowed stock when not economically exposed, and managers having the internal compliance and other arrangements to ensure proper market conduct and prevent market abuse.

Area of concern	Issue	Overview of best practice standards
Market abuse	Do hedge fund managers comply with applicable law and regulation on market abuse?	• Managers should at a minimum ensure that they have internal compliance arrangements to identify, detect and prevent breaches of market abuse laws and regulations and disclose to investors that it has a policy in place (no disclosure of the actual policy is required)
Shareholder conduct: Proxy voting of stock owned	Hedge fund managers have become significant participants in equity markets, but do managers fulfil their duty to vote proxies where it is in the best interest of investors?	• Managers should have a proxy voting policy in place, to be made available to investors upon request
Shareholder conduct: Disclosure of derivative positions	Do hedge fund managers use derivatives to avoid disclosure of (economic) positions in companies, which, if they owned the stock directly, would have to be made public?	• The HFWG acknowledges that companies have a right to know who owns them • The HFWG therefore recommends regulators to take action to introduce a regime (similar to the UK Takeover Panel) requiring notification of "economic" interest
Shareholder conduct: Voting on borrowed stock	Is it appropriate for hedge funds to borrow stock to vote while not economically exposed?	• Hedge funds following best practice will not engage in activities, such as voting on borrowed stock, while not economically exposed

4. Conformity with the standards

4.1. What is "comply or explain"?

This report identifies 15 issues for which best practice standards are put forward. The standards result from an industry initiative. The value of these standards will only be established if they are conformed to. The word "conform" is used deliberately. There are two options in relation to each standard. Either firms can comply with that standard, or they can decide for a variety of reasons not to comply, in which case the obligation is to explain why they have not complied. Either option will amount to conformity with the relevant standards.

In turn, two important questions arise:

1. To whom should the explanation be given? The approach here is the same for any other area of disclosure: namely, the explanation is owed to the investor and any other relevant stakeholder on whose behalf the standard has been created.

2. What is the nature of the explanation that should be given? Clearly a statement which merely says "We choose not to comply" does not constitute an explanation: it is merely a statement. The best way of approaching this is that, starting with the requirements of compliance, the explanation should be capable of being understood and accepted as reasonable by the person to whom it is made.

4.2. What gives confidence that the standards will be conformed to?

Clearly, there can be no certainty that breaches will not occur – as is true with statutory requirements. There are, however, a number of reasons why it is hoped that market forces are likely to encourage conformity and indeed compliance. These are:

1. **Peer group pressure**
   The standards are based on enlightened self-interest. They have been devised by leading practitioners to enhance the confidence that people have in the activities of individual managers and the sector as a whole. So managers with good intentions wishing to appear publicly as responsible will either comply or explain. This will place peer group pressure on others to conform. Failure to do so would be bad for business and confidence when compared with leading firms in the sector which have decided to adopt the standards. Moreover, improvements will require effort and commitment to change in behaviour and process. Firms which do comply will undoubtedly wish to see their peers adopting similar changes.

2. **Market pressure from investors**
   Many of the standards have been devised with investors in mind and reflect their legitimate interests. It is to be expected that stakeholders will take a close interest in the standards and seek to establish whether a particular firm complies with the standards and, if not, why.

3. **Continued relevance**
   The continued relevance of the best practice standards will be essential to ensuring continuing compliance or explanation. They will therefore need to be reviewed and updated on an ongoing basis to ensure that they remain relevant and both adapt to changes in the environment and reflect experience of the FSA's interpretation of what is required by the FSA's Principles. The mechanisms to achieve this are outlined in Chapter 6 *(Longer term and next steps)*.

Consultation question

- *Are there any comments/observations on the way in which we envisage conformity with the standards?*

4.3. Verification and disclosure of conformity

Hedge fund managers should verify regularly that they conform with the standards. This could be done by an in-house annual review of practices or engaging a third party service provider to verify and attest to compliance. Managers could then state their compliance with the standards on their websites, in offering documents and in the funds' annual reports. The HFWG encourages investors and lenders to consider conformity with the standards in their hedge fund due diligence.

Consultation question

- *What would be the best forum for disclosing conformity with the standards?*

5. Sector information

As they mature and grow in importance, industries tend to provide more authoritative and reliable information about the industry and the firms in it to satisfy legitimate interest. The media, civil servants, politicians and the public at large are better informed, which also benefits the industry itself.

The hedge fund industry is just reaching this stage. The industry has developed fast; the roots of the industry are closer to the closed world of private banking than they are to mainstream finance; the firms are still mostly privately owned; and there has been little incentive to create the necessary databases. Although sources of information do exist, access may be difficult and their scope and accuracy are uncertain. Moreover, definitional issues arise both in relation to identifying which firms are hedge funds, and as regards to investment strategies.

The leading firms in the sector now recognise that they should take action to rectify this data deficit. Improvement is needed in two areas: publicly available generic data about the sector; and information about individual firms. The HFWG proposes that leading hedge funds enhance the availability of data on the sector and of information about individual firms.

5.1. Information about the sector

The HFWG has agreed to collaborate with AIMA to develop a methodology for collating industry data, in order to make more information about the hedge fund industry publicly available. This could include basic information about the hedge fund industry, such as types of funds, definition of strategies and so on, as well as industry statistics (for example assets under management).

It is recognised that this initiative is UK-based and that the members of the group constitute only about half of the assets under management in the UK. Other members of the industry in the UK, including supporters of the HFWG are being asked to participate. AIMA is well placed to encourage this and ensure consistency, and even convergence, given the global nature of its membership.

5.2. Information on individual firms

In a UK context, the view has been widely held that information about individual managers may not be displayed on websites for fear of falling foul of the financial promotion regime in the Financial Services and Markets Act 2000 (which is designed to protect investors). However, provided the data published is factual and not promotional in nature (and provided any legal or regulatory issues in relation to non-UK jurisdictions are taken into account), financial promotion issues are unlikely to arise. It should therefore be possible for a hedge fund manager to publish, for example, a summary of the manager’s investment strategies, details of assets under management, an indication of the number of funds managed, its regulatory status and its history.

The HFWG encourages hedge fund managers to carry on their websites an appropriate amount of information about themselves.

5.3. Statement of conformity with best practice standards in this report

Finally, the HFWG encourages managers to announce their conformity with the HFWG’s best practice standards on their websites. Investors and the public will then be able to see for themselves how each firm has responded to the recommendations set out here. Chapter 4 *(Conformity with the standards)* covers this ground in more detail.

Consultation questions

- *Would improvements to visibility, as suggested above, be useful?*
- *What other areas of information related to the hedge fund industry would be of value, taking into account the constraints mentioned?*
- *Would stakeholders see merit in firms which conform to the standards confirming this on their websites?*

6. Longer term and next steps

6.1. Introduction

The best practice standards in this report are a first step. As discussed earlier, they are the result of the work by the HFWG, an *ad hoc* group of leading hedge fund managers. The HFWG was formed to kick start the creation and ownership of standards of best practice, building on existing material. The group believes this process should be ongoing, with the publication of this report being an important first step on a continuing road. The intention has been to show that hedge fund managers are taking seriously their long-term responsibilities as major actors in the financial world, and to clarify how they intend to live up to the FSA's Principles. The best practice standards set out in this report represent the most that could be achieved by this group within the time we allowed ourselves, and in the circumstances of the industry today.

If the standards are to command respect and legitimacy and their authority is to grow, a continuing process of iteration and gap filling is needed to cater for inevitable change in the environment and better understanding of the issues. In turn, there must be a mechanism to achieve this end. This chapter describes the HFWG's intentions in this respect.

6.2. The requirement

Three main factors will influence the further development of the best practice standards:

- First, changes in the environment. Among these are changes within the industry itself, standards of conduct or behaviour demanded by regulation, investors or society, the instruments traded and included in portfolios, and the provision of services to the industry.
- Second, there are inevitably gaps in the work we have undertaken. For example, we have not considered retail investor protection. Closer attention to this issue is likely to become more necessary as more retail and less sophisticated investors become investors in hedge funds.
- And third, the industry operates globally. There will be merit in seeing whether there are areas where best practices might be adapted to become of more global application. The question is considered in Chapter 7 *(The report in a global context)*.

6.3. The way forward

The process for managing the evolution of the standards needs to address several connected questions:

- Who will "own" the standards?
- How will the owners be selected and why should they be regarded as legitimate?
- What mandate will they have?

6.4. The proposal

Ownership of Standards: A "Board of Trustees" would be established to "own" the standards. These "Trustees" would have the experience and gravitas to command respect for their independence of thought and understanding of the industry and its stakeholders.

Selection: The selection procedure for the board of trustees will be decided upon during the consultation period. The initial selection would be made after consultation with senior members of the stakeholder community. Guidelines for appointments in the future would be laid down in a Mandate for the Trustees (aspects of which are described below). The rules or constitution of the body would be published.

Mandate: The HFWG will draw up the mandate, which will give the trustees responsibility to ensure that:

- The best practice standards are adapted over time, so that they continue to reflect the environment for hedge funds and the FSA's Principles and command wide respect.
- Gaps are identified and filled in.
- The evolution of the standards, particularly as they relate to financial stability, is considered in a global context.
- The standards meet the needs of the industry and its users.

The Trustees would not be regulators. They would be observers of the conformity or otherwise by the industry to the standards. They would not have sanctions, other than the power of publicly commenting on nonconformity.

The HFWG would publish the mandate. Any changes to this mandate which the Trustees might propose in future would also need to be published and consulted upon. This will help to strengthen the credibility of the Trustees because any attempt to weaken the standards at some later date would be a matter of public record, and no doubt debate.

The Trustees would publish an annual report on matters such as their evaluation of the impact of the standards, the extent to which they are being conformed to and changes to the environment.

The Trustees would not be governors of a trade association, nor would they have any regulatory standing. It is important that there would be no suggestion of them standing between the industry and the FSA, the statutory regulator in the UK, other than being guardians of standards which are designed to put flesh on the bones of the Principles laid down by the FSA. However, they would naturally need to be responsive to changes in the regulatory requirements.

The Trustees would be empowered to create an executive capability to carry out the work which they determine is needed to execute their mandate. This could either be in the form of engaging their own executive (as has been done by the International Accounting Standards Board ("IASB") for international accounting standards), or the services of third parties. It would be likely that any such third parties would include AIMA, given its membership and knowledge. Budgetary issues, including sources of finance from within the industry, would need to be considered.

Consultation questions

- *A Board of Trustees has been proposed as the next approach to ensure continuity for the HFWG. Are you comfortable with this recommendation vs other alternatives?*
- *If not, what other governance structures would be suitable?*
- *What mandate should the Trustees have?*
- *Should the funding be wholly provided by the hedge fund industry, or should the industry's users contribute?*

6.5. Other issues

The HFWG acknowledges that there is no widely used qualification curriculum in the UK that combines all the particular features of the hedge fund industry. However, there is an American based qualification, the Chartered Alternative Investment Analyst ("CAIA")[12], co-founded by AIMA. It has a UK chapter to which AIMA has contributed and the HFWG is also aware of existing curricula at institutions such as EDHEC, London Business School and Oxford University (Said Business School). In order to ensure that hedge fund managers in the UK have access to the training their staff need, the HFWG will work with industry bodies such as the Securities and Investment Institute and AIMA to complement existing curricula from a hedge fund industry point of view.

Consultation questions

- *Do industry practitioners agree that there is a need for more training specific to the hedge fund industry and, if so, what should the curriculum cover?*
- *Which of the relevant areas are not yet covered by existing qualification curricula (eg CAIA) and how should these gaps be filled (for example, complementing existing curricula, creating new stand alone qualifications, etc)?*

12 www.caia.org

7. The Report in a global context

There are two areas in which the best practice standards in this report are relevant to the global context: first, the future evolution of the UK standards; and second, the financial stability dimension.

7.1. Evolution of the standards

It is important to note that the HFWG has substantially been a UK-based initiative. There are two reasons for this.

- First, a significant proportion of global hedge fund activity is UK-based – some 20% – where our best practice standards are of direct relevance. Indeed, outside the US (see below) this represents a large majority of such activity. The proposals should therefore have some weight in a wider global context.
- Second, given the new ground that we have attempted to cover and the need to obtain consensus from a wide range of different participants, we deliberately chose to anchor the standards in the requirements of a single regulatory regime. As we have noted, managers authorised in the UK are already required to comply with the FSA's Principles. These Principles provide a powerful set of behavioural determinants and the standards are an articulation of how firms would intend to conduct their business in compliance with them. Notwithstanding the UK bias, it is important to note that the FSA's Principles are in many ways "universal" in their intent and they are not grounded in anything particular to the UK. Although other regulatory regimes may lack such overriding principles, they are based on widely held – indeed globally recognised – tenets of good business conduct. So we anticipate that the best practice standards outlined in this report will be of general value in other jurisdictions.

For the above reasons, and given the global nature of the industry, there would be merit in seeing how these standards might evolve to reflect the global dimension, perhaps leading to convergence with standards published in other countries on a number of areas of best practice. Indeed, there may be areas where the standards could be adapted so that they are capable of global application. Areas such as risk management, based as they are on a series of globally relevant technical and judgmental factors, for example, might well fall into that category.

The following are also significant:

- First, the initiative taken in September 2007 by the President's Working Group in the US to create an Asset Manager Committee whose initial focus will be on practices for hedge fund managers. The scope and intent of this group is similar to our own as they intend to build on existing industry work. This is a highly significant move, given that some 65% of hedge fund activity globally is in the US. The UK and US initiatives will thus together cover a very high proportion of global hedge fund management activity. There have been initial contacts between our two groups, and looking to the future, the proposed mandate of the Board of Trustees who would continue to own the UK standards (see above) would include reference to the need to retain and develop this cooperative relationship.
- Second, there would be merit in holding further discussion with industry groupings in other countries and with global authorities such as the Financial Stability Forum and IOSCO. It would be intended that this too would be outlined in the mandate of the Board of Trustees.

- The intent of the above areas of contact would be both to ensure that the UK-based standards conform to the global environment and to consider areas where the standards might converge globally.

7.2. The financial stability dimension

Given the global nature of the hedge fund industry's operations and assets under management, the significance of the standards and the behaviour they induce are of relevance beyond the jurisdictions in which the firms are based. We have been conscious of this when creating the standards.

A particular issue often raised by supervisors and others is concentrations of risk and the potential for such concentrations to be unwound in periods of stress. The unwinding process would be cause for concern to the extent that it exacerbated underlying instability. Such concentrations of course are found not only in the hedge fund world, but also in other areas such as investment banks, commercial banks, large corporations, foreign wealth funds and insurance companies, to say nothing of major private holders.

However, hedge funds occupy a particular position of size and influence and accordingly the question of concentrations within the hedge fund sector remains a significant point. The area contains several tricky questions:

- First, where are they, and how big are they? Trying to identify their location and to measure their size might suggest that an attempt be made to analyse the positions of individual firms and in aggregation. The problem here is partly the proprietary nature of the information. Even if the data could be collected in a timely manner, the speed with which risk positions can be transferred and the complexity of the analysis of positions means that any theoretical study of positions would be fraught with problems of interpretation.

- Second, hedge funds do indeed have big positions. But so do almost all the major global investment and commercial banks through their proprietary trading desks as well as their customer risk-taking activities. This is also true for a variety of other major investors including central banks, sovereign wealth funds, corporations and long-only asset managers. Many of these are just as capable as hedge funds of trying to shift positions in periods of stress. The value of looking at hedge fund positions in isolation would to that extent be reduced.

- Third, concentrations of risk, even with no change in the underlying assets, are dynamic. As we have seen recently, asset classes which appear not to be correlated can become highly correlated at times of stress and hence cause unexpected forms of concentration to appear at the very time that they are least welcome. One response has been calls for a "register" type approach to firms' risk positions. Such calls have lessened in recent years as the issues mentioned above have become better understood and the realisation has grown that using whatever data might be compiled would contain its own hazards.

For this reason, the approach taken in this report – and this is a major strand in the best practice standards – is for firms and their supervisors to pay significant attention to risk management.

- If supervisors realise that it is not easy to make judgements about financial stability by collecting and analysing data on concentration positions, a powerful alternative mitigant of concern is for them to have confidence in the robustness of the risk management frameworks of hedge fund managers: for example, to understand how such firms think about their risks, how they measure them and how they control and manage them.
- This is why we have emphasised the "framework" of risk management in this report. It is not just the investors in the funds who need to have comfort that risks are well managed, but it is also important for the broader public interest.

Within the risk management framework of each firm there are two features of particular significance for financial stability:

- First, the way in which firms think about liquidity management risk. This is the area in the risk management process which ultimately would be likely to contend with any forced mass sale of assets. Such sales could occur in times of stress as firms might seek to withdraw from concentrations and create sufficient cash to handle margin calls and demand for redemptions.
- Second, the approach firms take to stress testing and scenario planning, which can be used to evaluate how concentrations of risk might unexpectedly appear if and when correlations between asset classes rise during times of stress.

It is certainly noteworthy that, to date, there appears to be little evidence that leading hedge funds have withdrawn en masse from positions during the critical credit conditions prevailing since July 2007. However, this should in no way be a cause for complacency. Firms and their supervisors have much more to do in trying to understand the dynamics which might lead to instability. The HFWG members therefore welcome dialogue with the supervisors on financial stability issues. It is in their own interests and that of their investors, as well as being a demonstration of their acceptance of the broader responsibilities which come with size, success and influence. This is now the norm in the UK for the main hedge funds which are large enough to be significant to financial stability. Such dialogue will need to continue: the HFWG members stand ready to play their part.

Appendix A. Members of the Group

The HFWG includes the following 14 hedge fund managers, of whom 12 are UK-based:

- Brevan Howard, Nagi Kawkabani
- Brummer, Klaus Jäntti
- Centaurus-Capital, Bernard Oppetit
- Cheyne Capital, Stuart Fiertz
- CQS, Michael Hintze
- Gartmore, Jeffrey Meyer
- GLG, Manny Roman
- Lansdowne Partners, Paul Ruddock
- LDFM, Rob Standing
- Man Group plc, Stanley Fink
- Marshall Wace, Paul Marshall
- Och Ziff, Michael Cohen
- RAB, Michael Alen-Buckley
- Sloane Robinson, George Robinson

The Alternative Investment Management Association (AIMA), (Florence Lombard and Andrew Baker). AIMA has been a permanent observer throughout the process.

The areas in which the HFWG focussed its attention are Risk, Disclosure, Valuation and Activism. Focus groups for each comprised:

Risk	Stanley Fink, Man Group plc – Co-Chair Manny Roman, GLG – Co-Chair Les Aitkenhead, Gartmore Antony Elliott, Man Group plc Dr Robert Hillman, LDFM Jonathan Howitt, Man Group plc	Klaus Jäntti, Brummer Henrik Johansson, Brummer Jeffrey Meyer, Gartmore Patrick Trew, CQS
Disclosure	Stuart Fiertz, Cheyne Capital – Co-Chair Paul Marshall, Marshall Wace – Co-Chair Les Aitkenhead, Gartmore Stephen Couttie, RAB Adam Glinsman, Lansdowne Partners	Nick Hunt, CQS Jeffrey Meyer, Gartmore George Robinson, Sloane Robinson
Valuation	Aron Landy, Brevan Howard – Chair Neil Cosgrove, D E Shaw Tanya Farrell, Sloane Robinson Gary Ibbott, Cheyne Capital	Andrew Johnston, Man Investments Martin Pabari, CQS David Prance, RAB
Activism	Bernard Oppetit, Centaurus – Chair David Burnett, TT International Michael Cohen, Och Ziff	Simon James, Cheyne Capital Cathy O'Reilly, TCI Fund

Appendix B. FSA Principles

	Principle	Description
1	Integrity	A firm must conduct its business with integrity
2	Skill, care and diligence	A firm must conduct its business with due skill, care and diligence
3	Management and control	A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems
4	Financial prudence	A firm must maintain adequate financial resources
5	Market conduct	A firm must observe proper standards of market conduct
6	Customers' interests	A firm must pay due regard to the interests of its customers and treat them fairly
7	Communication with clients	A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading
8	Conflicts of interest	A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client
9	Customers: relationship of trust	A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment
10	Clients' assets	A firm must arrange adequate protection for clients' assets when it is responsible for them
11	Relations with regulators	A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice

Appendix C. The Hedge Fund sector: History and present context

C.1. What is a hedge fund?

The term hedge fund was originally used to describe a type of private investment fund that charges investors a performance fee, uses leverage to magnify returns and short selling to limit market risk. This description still fits many hedge funds but by no means all.

There is no legal or regulatory definition of a hedge fund in the UK and the range of funds covered by the term is very wide. Not all use leverage. Not all engage in short selling. And a few are now even quoted and open to retail investors.

As a result hedge funds are easier to recognise than to define. However, they tend to share certain characteristics and are generally susceptible to the elephant test: although hard to describe, you know a hedge fund when you see it.

It is important to distinguish between hedge funds and hedge fund managers - the asset managers that manage the fund. In contrast to traditional, long-only asset managers, hedge fund managers tend to have a number of extra tools in their toolkit, which they use to increase returns and manage investment risk. They include:

- Going short of stock to generate returns and/or hedge market exposure. Going short involves borrowing stock and then selling it in order to profit from the value of the security falling.
- Using leverage to magnify returns. Leverage in this context means buying securities using borrowed money.
- Employing derivatives to generate returns and/or reduce risk. Derivatives can be a very efficient way of increasing exposure and therefore potential profit/loss or of hedging exposure thereby reducing risk.
- Trading much more actively than traditional managers.

But none of these characteristics define hedge funds because, while some hedge funds will share some or all or many of these characteristics, others do not. For instance, as mentioned above, not all funds use leverage or derivatives. Equally, some equity hedge funds are not hedged in the traditional sense (some would argue these are not true hedge funds) and most have a net long exposure to the market.

Perhaps the one feature that is common to virtually all hedge funds is the fee structure. Typically hedge funds will charge investors a management fee of 1.5-2.0% and a performance fee of 20%. This means managers are heavily incentivised to generate good performance for investors.

C.2. The focus of the HFWG report

The focus of the HFWG report is on the hedge fund managers, and the best practice standards apply to them. The majority of the HFWG members are based in the UK, the centre of the European industry, although many of the funds they manage may be registered offshore. In this respect, hedge fund managers are no different from many traditional asset managers which often manage offshore registered or domiciled funds.

C.3. Funds of hedge funds

This report is not about best practice standards of funds of hedge funds. Unlike a hedge fund manager, a fund of hedge funds does not invest in underlying shares or securities but invests clients' money in a collection of individually managed hedge funds in the same way as other investors do. The skill of funds of hedge funds lies in picking successful managers and, for this, funds of hedge funds will typically charge a 1% management fee and a 5-10% performance fee.

C.4. History of hedge funds

The father of the modern hedge fund industry was a financial journalist called Alfred Winslow Jones. Jones was born in Australia in 1901 but brought up from the age of four in the US. He graduated from Harvard University and was a US diplomat in Berlin in the 1930s. He later joined Fortune, the US business magazine, where he became interested in investment and established an investment partnership.

He structured the fund as a limited partnership with fewer than 99 investors to avoid the regulatory requirements of the US Investment Company Act of 1940 and for the general partner or fund manager to take 20% of profits as compensation. His investment approach involved using leverage to increase exposure and magnify returns while at the same time using short selling of stocks to remove market risk. His aim was to hedge out market risk by taking as many short positions as long positions so that his fund was "market neutral". In other words, returns would depend not on whether the stock market went up or down but purely on whether he picked the right stocks.

When Fortune published an article about Jones in 1966, dozens of others began to follow his approach.

In its early years, the hedge fund industry remained relatively small and attracted little publicity. But the number of hedge funds, and the total assets under management began to increase significantly during the 1990s and the rate of growth has accelerated enormously in the last few years.

There were a number of reasons for this growth. First, the attractiveness of the hedge fund remuneration structure was a big incentive to talented traders and investors to leave investment banks and large asset managers to set up on their own. Second, the intellectual freedom afforded by running your own hedge fund and not being bound by the institutionalised, benchmark-driven approach of many traditional asset managers lured many talented investors to the hedge fund world. Third, advances in technology made it much easier for talented individuals in the financial industry to set up their own investment boutiques, outsourcing back office functions to large suppliers.

C.5. Where the industry has got to now

Today the hedge fund industry has some of the most talented people in the financial industry among its ranks. The activity of some hedge funds is very similar to that of the proprietary trading desks of the big investment banks while others fall more into the category of long-term investors.

There are various different sources of data about the size of the hedge fund industry which are not entirely consistent. However, according to International Financial Services London (IFSL), there is an estimated $1,500 billion of hedge fund assets under management globally (12/2006)

compared with $1,000 billion at the end of 2004 and only $130 billion in 1996.[13] Over the same period, the number of hedge funds has grown from 130 in 1996 to 9000 in 2006.

The majority of hedge fund assets are managed out of the US, which accounts for an estimated 65% of global hedge fund assets, down from 82% in 2002. Europe accounts for 24% of hedge fund assets, with four-fifths of European hedge fund investments managed out of the UK.[13]

The early investors in hedge funds were high net worth individuals and their family offices, often family or friends of the fund manager, in keeping with the private investment partnership approach. US endowments such as the universities of Yale and Harvard were among the first institutional investors to start investing in hedge funds, but now a broad array of institutional investors, including many big pension funds, have investments in hedge funds.

This has contributed to the institutionalisation of the hedge fund industry as institutional investors tend to favour bigger funds with well-developed compliance and risk management functions. The result has been the concentration of a significant proportion of hedge fund assets among a small number of big managers.

The majority of hedge funds are private open-ended investment vehicles, although an interesting recent development has been the emergence of closed end quoted funds that are aimed at a wider market including retail investors.

C.6. The range of investment styles

Hedge funds are often described as an asset class but this is misleading. Some hedge funds do share certain return characteristics but they invest in a broad range of different asset classes ranging from equity to debt, real assets and even property.

Equity hedge funds are the largest single category and most of these are long/short equity funds. They may be investing in domestic or international stocks. Sometimes these funds can be market neutral. However, it is rare that they have no exposure to the equity market, following the model pioneered by Alfred Jones. In practice such funds are generally net long but limit their market exposure by selling some stocks short. As a result their returns are not fully correlated to the equity market.

Other hedge funds embrace a range of different strategies aimed at generating absolute returns. They include credit or fixed income hedge funds, convertible arbitrage, merger or event arbitrage, multi-strategy arbitrage and distressed securities. Another significant group of hedge funds falls into the macro category; these funds focus on macroeconomic conditions, taking leveraged bets on the direction of currencies, interest rates, commodities and stock markets.

The following chart provides a breakdown of the different types of hedge funds by investment strategy.

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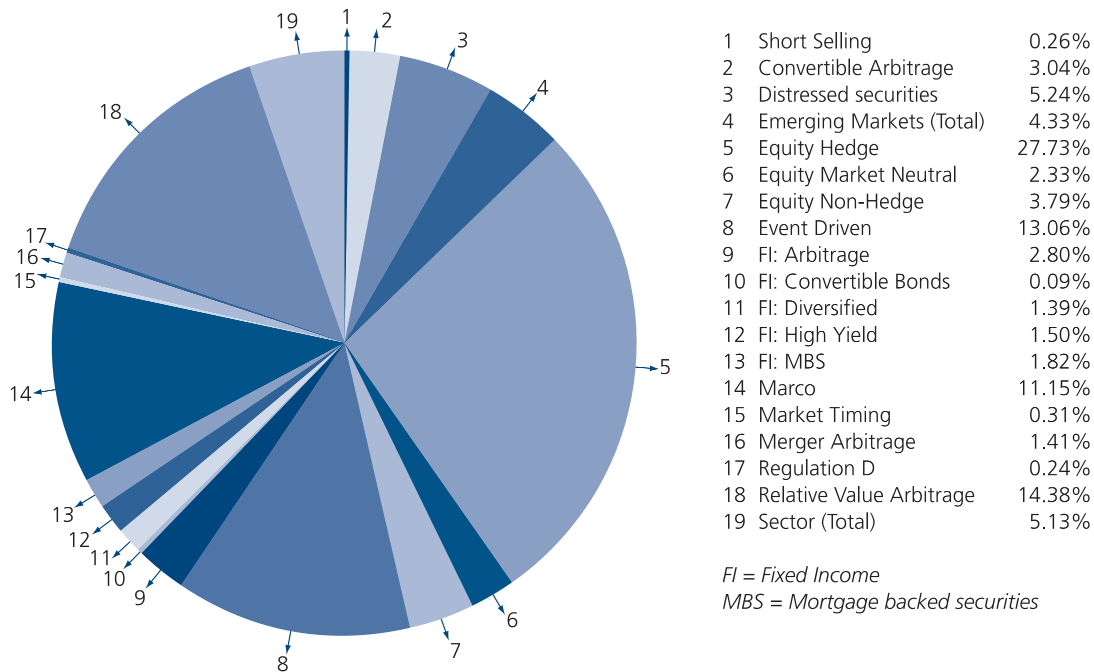
13 Source: International Financial Services London: Hedge Funds City Business series, http://www.ifsl.org.uk/uploads/CBS_Hedge_Funds_2007.pdf. Other sources indicate $2,593 billion of total assets under management for Q2/2007, Hedge Fund Net.

Breakdown of assets under management by strategy[14]



C.7. Private equity and hedge funds

Hedge funds are often compared with private equity but the two industries are very different. Private equity funds generally make a limited number of large, illiquid investments in unquoted companies. Often they take controlling stakes in companies and investors in private equity funds may be locked in for up to ten years.

By contrast hedge funds generally invest in more liquid, tradeable securities and investors can usually withdraw their money with monthly or quarterly notice periods.

However, there has been some convergence between the two industries. On rare occasions hedge funds have bought companies outright and some hedge funds invest in unconventional, illiquid assets ranging from venture capital to film production.

C.8. The regulatory regime for hedge funds

Hedge funds are often referred to by the media as an unregulated industry. This is not the case in the UK where any hedge fund manager engaged in investment management activity must be authorised and therefore regulated by the FSA. This requires being considered by the regulator as fit and proper to conduct investment business and involves an obligation to comply with the FSA's Principles, rules and guidance. All hedge fund managers operating in the UK are covered by this regulatory regime whether they are managing money for UK investors or for investors based overseas.

14 Hedge Fund Research (Q2 2007).

In other words, all hedge fund managers in the UK are regulated. Even though the funds themselves are often based offshore in foreign jurisdictions such as the Cayman Islands or British Virgin Islands and are not regulated by the FSA, a UK-based manager is still under an obligation to comply with the FSA's Principles in respect of any offshore fund which it manages.

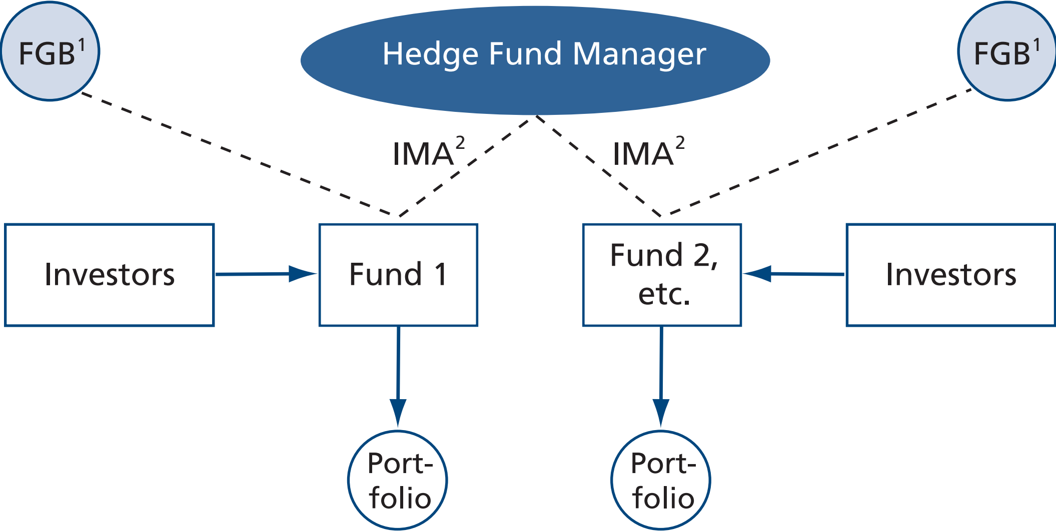
The situation in the US is different in that many hedge fund managers employ the "private adviser exemption" from registration with the Securities and Exchange Commission which is available provided the hedge fund manager (i) has fewer than 15 clients during the proceeding 12 months;[15] (ii) does not hold itself out generally to the public as an investment adviser; and (iii) is not an adviser to any registered investment company.

C.9. Conclusion

The term "hedge fund" is used to cover a huge range of investment vehicles, which invest in a large variety of strategies. The defining feature has been the manner in which this investment is carried out. To date the wording has seemed appropriate. However, in future the generic term will become less important and more emphasis will be given to the strategy or range of assets that the manager specialises in. Whatever happens in the future, the way hedge funds are structured and the way they go about their business give them enough in common to justify this report's best practice recommendations.

15 A legal entity that receives investment advice based on its investment objectives can be counted as one client for the purpose of determining whether the adviser qualifies for the private adviser exemption. Thus, a hedge fund manager can count a hedge fund as one client regardless of the number of investors that hold a beneficial interest in it. The Securities and Exchange Commission attempted to change the method of counting towards the 15 client threshold by the adoption of a rule (Rule 203(b)(3)-2) in December 2004 that would have made managers look though the fund and count every investor as a client. The effect of this rule would have been that most managers would have been unable to rely on the private adviser exemption. The rule was vacated and remanded by the US Court of Appeal in June 2006.

Appendix D. Simplified illustration of typical hedge fund structure



1. Fund Governing Body
2. Investment Management Agreement

Appendix E. Consultation questions

The HFWG is seeking input to its proposed best practice standards. It is therefore inviting supervisors, central banks, companies, investors and others who take interest in the hedge fund sector to provide feedback.

In addition to answers to the questions below, we would welcome any other comments or observations on either or both of Parts 1 and 2 of this report.

Part 1	Page	Consultation question
Introduction – best practice standards	14	Are there further issues that should be addressed by the HFWG?
Conformity with the standards – what gives confidence that the standards will be conformed to?	22	Are there any comments/observations on the way in which we envisage conformity with the standards?
Conformity with the standards – verification and disclosure of conformity	22	What would be the best forum for disclosing conformity with the standards?
Sector information	24	Would improvements to visibility, as suggested above, be useful?
		What other areas of information related to the hedge fund industry would be of value, taking into account the constraints mentioned?
		Would stakeholders see merit in firms who conform to the standards confirming this on their websites?
Longer term and next steps – the proposal	27	A Board of Trustees has been proposed as the next approach to ensure continuity for the HFWG. Are you comfortable with this recommendation vs. other alternatives?
		If not, what other governance structure would be suitable?
		What mandate should the trustees have?
		Should the funding be wholly provided by the hedge fund industry, or should the industry's users contribute?
Longer and next steps – other issues	27	Do industry practitioners agree that there is a need for more hedge fund industry specific educational training, and if so, what relevant areas should the curriculum cover?
		Which of the relevant areas are not yet covered by existing training curricula and how should these gaps be filled? (eg complementing existing curricula, creating new stand alone training, etc)?
Part 2	**Page**	**Consultation question**
Introduction	8	The standards proposed in this document are largely based on disclosure rather than more prescriptive description of behaviour and practices. Would smaller hedge fund managers find such a disclosure-based approach difficult to comply with?

Part 2	Page	Consultation question
Introduction	8	If the currently proposed practices do pose challenges for smaller funds, specifically which practices are toughest and how would the funds suggest addressing those issues in lieu of our recommendations?
		Do the best practice standards strike the right balance between disclosure on the one hand, and the need for flexibility and innovation on the other?
Disclosure to investors and counterparties – Investment policy and risk disclosure	10	Would the disclosure standards as articulated be sufficient in breadth and clarity to enable potential or actual investors to make well-informed decisions? Are there areas where further disclosures are required?
Commercial terms disclosure	12	Would the proposed disclosures give investors a sufficient understanding of relevant commercial terms, such as fees, expenses and termination rights?
Disclosure to lenders/prime brokers/dealers	14	Are additional disclosure standards required for either creditors or other third parties to enable them to make well-informed decisions?
Valuation: segregation of the valuation and portfolio management functions	17	Given the importance of independence from the portfolio management function, are the improved valuation policies and procedures sufficient to meet the needs of investors?
		Should there be a more substantial role for administrators or other third parties in the valuation process beyond that set out in the HFWG report?
Valuation: difficult-to-value assets	21	Do the proposals for valuation of illiquid assets provide investors with sufficient confidence that pricing would be done in a fair, dependable and consistent manner?
Prudential and risk issues	23	Are there other aspects of the proposed risk framework which are not laid out in the practices which should be considered?
	37	Please comment on the proposal in relation to each of the specific areas of risk for which best practice is proposed: a) Portfolio risk, b) Operational risk, c) Outsourcing risk.
		Will the above approaches provide investors and counterparties with sufficient understanding and comfort about the handling of risk?
Fund governance	41	Have we adequately covered the main issues in relation to this increasingly important area?
Market issues and activism	45	Are the governance and disclosure standards a useful addition towards market integrity?
		Would other market participants equally value clarification or improved definition as to what constitutes a" concert party"?

Part 2	Page	Consultation question
Market issues and activism; proxy voting of stock owned	46	To what extent would consultees value this new requirement?
Market issues and activism: shareholder conduct: disclosure of derivative positions	47	Would other consultees be prepared to enter debate about improved disclosure (eg of contracts for difference)?
Market issues and activism: shareholder conduct: voting of borrowed stock	48	Would other consultees value a wider debate aiming at voting being restricted to those holding economic interest?

Appendix F. Acknowledgement

Members of the HFWG have, since this project's inception, contributed a substantial amount of their resources and expertise to put forward these best practice standards. However there have been other organisations who have committed time and effort to this endeavour.

I would therefore like to thank the following who have assisted the HFWG in producing this document:

- Oliver Wyman – for full time operational, project management and content support for the project.
- Herbert Smith – for legal counsel and major help in drafting.
- Quiller Consultants – for public handling, including substantial input to the text.
- Ernst & Young – for general advice, particularly in the accounting and governance fields.

In particular, Brad Ziff and Thomas Deinet of Oliver Wyman have energised the process.

Additional thanks go to my assistant, Karen Williams, who has supported both me and the project throughout our endeavour and to Michael Prest, who acted as editor of the consultation paper.

Despite not being members of the HFWG the following firms contributed members of their staff, who ably assisted our Focus Groups:

- TCI
- The DE Shaw Group
- TT International

As noted at the outset, a project of this nature is a very substantial undertaking; all those mentioned above have contributed hugely over the past few months to what I hope is considered a worthwhile exercise: my thanks are due to all of them.

Sir Andrew Large

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