

October 2007

Hedge Fund Standards: Consultation Paper
PART 2: The best practice standards

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Notes on consultation

The Hedge Fund Working Group (“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 and are also provided in a separate table (Appendix F), 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 paper. The best practice standards are highlighted in blue-shaded boxes in Part 2 of the paper.

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 paper 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 E.

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 which confront this rapidly growing industry.

1. Introduction

This second part of our report spells out a series of best practice standards which the HFWG members have drawn up to show how they intend to comply with the spirit and sense of the Financial Service Authority's ("FSA's") 11 Principles. These standards clearly need to be significantly more granular than the FSA's Principles, imbuing them with practical substance. But, equally, they are not intended to be prescriptive or to lay down detailed rules. Instead, they are industry-led standards of a general nature designed to accommodate a very diverse industry.

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's Principles applicable to FSA authorised managers. 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.

The HFWG recognises that industry best practice may differ from country to country for a number of reasons, including legal, regulatory and practical considerations. The standards in this report have therefore been designed primarily for managers whose principal operations are in the UK and which are regulated by the FSA. We intend, however, to work with other non-UK managers and industry bodies to bring about convergence of best practice standards across the principal countries in which hedge funds operate.²

Our approach has been for the HFWG members first to identify certain key issues facing the hedge fund industry and then to consider the best practice approach to these issues in light of the FSA's Principles. The result is that the HFWG has identified 15 issues for which it has created best practice standards. We refer to existing work on best practice standards for these issues where it illuminates the topic, avoids duplication and helps the industry to adopt the standards. The 15 issues can be grouped under four headings:

- Investment policy, risk and commercial terms disclosure
- Valuation
- Risk
- Activism

The issues in turn have two overarching themes: governance and transparency.

1.1. Governance

Hedge fund managers can only meet best practice standards if their governance enables them to conform with the standards. Where relevant, each best practice standard in this report contains a section on the governance mechanisms necessary to achieve that goal. Governance mechanisms in this context include management, organisation and identification of where within the management company ultimate responsibility for decision taking lies. Ensuring that governance mechanisms and processes are effective includes, amongst other things:

- **Within** organisations
 - Ensuring integrity and competence of personnel
 - Ensuring governance processes are fit for purpose

² Also see Section 7 (The report in a global context) in Part 1 of this report.

- Maintaining segregation of duties where potential conflicts exist, including identifying with whom ultimate decision making authority lies
- Obtaining assurance from third parties (such as auditors) that governance processes and controls are fit for purpose
- Where functions are **outsourced**
 - Conducting due diligence to ascertain that services are provided to the required standard
 - Conducting due diligence to ensure that potential conflicts within the service provider (who may for instance provide multiple services to the manager) are suitably controlled

Such mechanisms are of particular importance where potential conflicts could arise, including, for example, in relation to:

- Valuation, where valuation should be conducted independently of portfolio management
- Risk management, where adherence to the stated investment policy needs to be ensured
- Compliance, where separate oversight is required to ensure adherence to law and regulation

1.2. Disclosure and Transparency

We put particular emphasis in this report on the desirability of improved disclosure and transparency. They are essential components to improve understanding of how the industry operates and help investors and others to see how managers seek to live up to their responsibilities. Disclosure also assists stakeholders in making better-informed decisions about a manager or fund.

It is important to note that in many respects the standards rely on disclosure rather than more prescriptive description of behaviour and practices. This gives sufficient freedom for innovation and avoids placing undue hurdles in the path of smaller hedge fund managers, or new market entrants, who may not be able to comply with a detailed and prescriptive set of operational guidelines.

Disclosures may be of several types, including:

- Statements as to specific facts or intentions in relation to behaviour or investment strategy, such as are found typically in a fund’s offering documents, marketing materials or investor updates
- Statements concerning how a manager individually intends to comply with particular standards: for example, how the firm proposes to think about its “risk framework”
- Statement of overall conformity, on a comply or explain basis, with the standards in this report: for example, on firm websites or in marketing materials and updates

Disclosures, furthermore, may be considered to have greater or lesser relevance for different parties depending on who is the main stakeholder for the particular best practice standard. For example, many disclosures are designed to assist investors in making better informed investment decisions while others are aimed at compliance with law or regulations or to provide comfort to

supervisors about issues of financial stability. Another type of disclosure is designed to enable lenders to make well-informed lending decisions.

1.3. Consultation questions

- *The standards proposed in this document are largely based on disclosure rather than more prescriptive description of behaviour and practice. Would smaller hedge fund managers find such an approach difficult to comply with?*
- *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?*

2. Disclosure to investors and counterparties

There are several areas where adequate disclosure is required:

1. Investment policy and related risks, which relates to disclosure of the investment strategy and risk profile of the fund to investors (Section 2.1)
2. Commercial policy, which relates to disclosure of the commercial basis on which the manager has agreed to manage the fund and on which investors will invest (Section 2.2)
3. Performance measurement (Section 2.3)
4. Counterparty disclosures, such as to prime brokers (Section 2.4)

2.1. Investment policy and risk disclosure

2.1.1. Background

Investment policies, investment strategies and risk profiles can vary significantly between funds. Ensuring that these are carefully explained in a fund's prospectus or other marketing material is therefore vital to enable investors to make well-informed decisions when investing and monitoring that investment. The HFWG has identified the following issues on investment policy disclosure:

- Do hedge fund managers provide sufficient information to investors as to the investment policies, strategies and the potential risks associated with the strategies and techniques used to generate returns?
- Do hedge fund managers adhere to any standard guidelines for reporting on investment policy?

2.1.2. FSA Principles

Relevant FSA Principles include:

- (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 with them in a way which is clear, fair and not misleading.

2.1.3. Best practice standards and guidance – Disclosure³

- **Managers should carefully consider the appropriate level of disclosure and explanation of its investment policy/strategy and associated risks in the fund's offering documents and marketing materials. When doing so they should take into account the nature (that is, the identity and sophistication) of potential investors.**

As a minimum this should include:

- A full description of the investment strategies and techniques employed and prominent disclosure of the risks involved
- General details of the investments and instruments (including, for example, derivatives) in the portfolio and prominent disclosure of the risks involved

³ In conforming to this best practice standards, managers may wish to consult the guidance contained in MFA 2005 Sound Practices for Hedge fund Managers (eg 2.2, 2.5) as well as the CFA Institute's Asset Manager Code of Conduct – Section F (Disclosure) and AIMA's Guide to Sound Practices for European Hedge Fund Managers (2007).

- Details of any investment restrictions or guidelines and of how breaches will be dealt with
 - A statement of the manager’s view of the fund’s risk profile relative to other types of funds
 - An explanation of the circumstances in which the fund may use leverage, the source of such leverage and details of any restrictions on the use of leverage (together with a description of the fund’s leverage profile as anticipated by the manager)
 - Prominent disclosure of the risks involved in employing leverage
 - Details of how the investment policy can be changed, how investors will be notified of any changes and whether investors and/or the fund governing body will be consulted on, or asked to consent to, any such changes
- **Managers should carefully consider the appropriate mechanism, given the nature of potential investors, for changing the fund’s investment policy/strategy. This may range from prior investor/fund governing body consent to consultation to mere notification.**
 - **Managers should ensure that the annual accounts of each fund include a review of adherence to the fund’s stated investment policy over the previous year.**

2.1.4. Consultation question

- *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?*

2.2. Commercial terms disclosure

2.2.1. Background

Of great importance to investors are the commercial terms of hedge funds. They include terms, for example, in relation to management and performance fees, expenses, minimum “lock-up” periods during which an investor is unable to exit its investment, redemption notice periods, redemption penalties and any powers to defer redemptions. Adequate disclosure is therefore necessary to enable investors to make well-informed investment decisions.

The HFWG has identified the following issues on disclosure of commercial terms:

- Do hedge fund managers provide adequate disclosure to investors about the commercial terms applicable to an investment in their funds?
- Are any changes to such commercial terms adequately disclosed to investors?

2.2.2. FSA Principles

Relevant FSA Principles include:

- (1) Integrity – a firm must conduct its business with integrity.
- (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 with 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.

2.2.3. Best practice standards and guidance – Disclosure⁴

- **Hedge fund managers should carefully consider, given the nature of potential investors, whether the commercial terms applicable to a particular hedge fund are disclosed in sufficient detail and with sufficient prominence in the fund’s offering documents/marketing materials to enable investors to make informed investment decisions.**

As a minimum this should include:
 - *Fees and expenses*
 - Fair disclosure of the methodology used to calculate performance fees
 - Details of any other remuneration received by the manager in connection with its management of the fund (this will be relevant, for example, where a hedge fund is a “feeder” fund into another fund managed by the same manager)
 - The basis of calculation for any base management fee and details of any expenses which may be payable or reimbursed to the manager in addition to the management fee by the fund
 - To the extent possible, the amount of and/or method of calculating the fees payable to the fund’s other service providers
 - *Termination rights*
 - Details of the circumstances in which the fund is entitled to terminate the manager’s appointment and the terms (for example in relation to termination fees) of such termination
 - *Exit terms*
 - For open-ended funds, full and prominent disclosure of:
 - a. The period of notice investors are required to give to redeem their investment in the fund
 - b. Details of any redemption penalties
 - c. Any “lock-up” periods during which an investor will be unable to redeem its investment in the fund
 - d. Any circumstances in which normal redemption mechanics might not apply or may be suspended

⁴ Managers may wish to consult further guidance, as set out by MFA’s 2005 Sound Practices for Hedge Fund Managers (2.6, 6.9) and GIPS guidance on disclosure of fees and cost (section F), www.gipsstandards.org

- **Hedge fund managers should ensure that any changes to commercial terms are disclosed to investors.**
The fact that the fees and expenses payable to service providers may change should be clearly disclosed in the fund’s marketing materials. Any such changes should be communicated to investors promptly.
- **Where a hedge fund or hedge fund manager enters into side-letters conferring preferential commercial terms on certain investors (eg preferential liquidity terms or greater transparency), hedge fund managers should ensure that the existence of such side-letters is disclosed to all other investors in the same pool of assets⁵.**
- **Hedge fund managers should seek to ensure that the fund’s financial statements are prepared in a way which allows investors to verify the actual fees in the financial statements against the basis of calculation set out in the fund’s marketing materials and to assess the impact of such fees on the fund’s performance.**
For example, the categories and captions in the fund’s financial statements should correspond to those used in the fund’s marketing materials so they can be easily compared
- **On establishing a fund, hedge fund managers should liaise with the fund’s administrator to ensure that the methodology for calculating fees (and in particular performance fees) is agreed in advance and accurately described in the fund’s offering documents/marketing materials and reflected in the annual accounts.**

2.2.4. Consultation question

- *Would the proposed disclosures give investors a sufficient understanding of relevant commercial terms, such as fees, expenses and termination rights?*

2.3. Performance Measurement

2.3.1. Background

Accurate and consistent reporting of investment performance enables investors to make well-informed judgements about their investments and allows them to compare different managers and hold them to account. The Global Investment Performance Standards (GIPS)⁶ provide a standardised approach to performance presentation to communicate investment results to clients and prospective clients. It is widely used among traditional asset managers and specific standards have recently been developed with specific applications to private equity. The existing standards are under review to include guidance to the hedge fund sector.

The HFWG has identified the following issue:

- Do hedge fund managers inform their clients in an adequate manner about performance?

⁵ Hedge fund managers should note, for example, the FSA’s views in relation to side-letters as set out in Feedback Statement 06/2 on Discussion Paper 05/4 entitled: “Hedge funds: a discussion of risk and regulatory engagement” and AIMA’s subsequent Industry Guidance Note on Side Letters, <http://www.aima.org/uploads/AIMAIndustryGuidanceNoteSideLettersMembers.pdf>

⁶ Administered by CFA Institute (www.gipsstandards.org).

2.3.2. FSA Principles

Relevant FSA Principles include:

- (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 with them in a way which is clear, fair and not misleading.

2.3.3. Best practice standards and guidance – Disclosure

- **Wherever performance is disclosed and funds have significant exposure to non-marketable or illiquid securities, reference should be made to factors which may be material to the robustness of the performance calculation, for example:**
 - The percentage of the portfolio in non-marketable securities
 - Method for valuation of illiquid or non-marketable securities
 - Use of side pockets

The HFWG welcomes the initiative of GIPS to review the applicability of their existing principles to hedge funds and would encourage them to involve hedge fund managers in this. Areas of particular relevance to hedge funds which need reviewing include:

- Clarity on the degree of disclosure of presence, use and extent of leverage in the form of derivatives
- Clarity on the approach to valuing instruments which cannot be based on market values
- Extent of disclosure of the valuation process, including disclosure of independence of valuation service providers and of the percentage of the portfolio not subject to stock market values

2.4. Disclosure to lenders/prime brokers/dealers

2.4.1. Background

Hedge fund managers rely on commercial and investment banks and other financing counterparties to provide extensions of credit and other forms of lending. Financing to hedge funds has evolved in a variety of ways from traditional prime brokerage vehicles (margin lending and stock borrowing) to synthetic and derivative instruments, and more recently to guaranteed, fixed and long-term facilities. The type of credit extended to hedge funds depends on a host of variables which the fund and the manager determine between them.

The amount of credit risk that counterparties will assume will be a function of the bilateral agreement with the hedge fund, in particular the collateralisation of positions. To assess the credit risk, counterparties will require information about the hedge fund and its positions.

It is normal for lenders to take responsibility for demanding satisfactory levels of transparency to enable them to make well-informed lending decisions. Supervisors and others have suggested that the provision of such information by hedge funds can be impeded *inter alia* by insufficient

protection of the confidentiality of that information within the lending institution. It is therefore essential that hedge fund managers recognise the importance of addressing any potential conflicts with the lender so that the lender can receive the necessary flow of information to make well-judged lending decisions.

For these reasons, the Counterparty Risk Management Policy Group II (CRMPG II) has recommended disclosure practices to improve transparency and counterparty credit assessments⁷. CRMPG II stated that, when determining how much information to provide on a confidential basis to their counterparties, market participants should recognise that provision of relevant credit data increases the level of the counterparties' comfort and improves the likelihood that access to credit will continue during periods of systemic and institutional stress. The HFWG endorses the breadth and direction of this practice and encourages the further work as being consistent with the types of best practices envisaged in this section.

The HFWG has identified the following issue in relation to disclosure to lenders:

- Are conflicts of interest between lenders and hedge funds identified?
- Do hedge fund managers provide lenders with sufficient information to assess risk adequately?

2.4.2. FSA Principles

- (1) Integrity – a firm must conduct its business with integrity.
- (2) Financial prudence – a firm must maintain adequate financial resources.

2.4.3. Best practice standard and guidance

- **It is recommended *“that credit users and OTC market participants seek a proper balance between preserving proprietary information and providing information that will enable their counterparties to gain an appropriate level of understanding of their management, investment process and philosophy and material risks.”*⁸**

The information provided to lenders might include risk management processes and measures agreed with the counterparty.

- **Hedge fund managers should provide the agreed information reports to counterparties in a timely manner.**

2.4.4. Consultation question

- *Are additional disclosure standards required for either creditors or other third parties to enable them to make well-informed decisions?*

^{7,8} Counterparty Risk Management Policy Group II (2005), Towards Greater Financial Stability: A Private Sector Perspective (07/2005), section III (Improving Transparency and Counterparty Credit Assessments), p. 46, <http://www.crmgroup.org>

3. Valuation

Valuation is the process of determining the value of a hedge fund's portfolio at a given time. Valuation is generally expressed as a single number it is important to recognise that the single number is merely the expression of a range of potential outturns that derive from the valuation process. It follows that investors need to be informed about the valuation process and have confidence in its robustness. For example, the valuation needs to be seen in the context of the depth of the market in the relevant asset. Given the fact that hedge funds are significant users of complex assets, where depth of market may be uncertain, this needs to be borne in mind when considering valuations.

For open-ended funds, the valuation is the basis for subscriptions to and redemptions from hedge funds by investors and measures the hedge fund's performance and affects the compensation of the hedge fund manager. Here, we identify two sets of issues about valuation: segregation of the valuation and portfolio management functions, and how to deal with illiquid assets.⁹

3.1. Segregation of the valuation and portfolio management functions

3.1.1. Background

For some hedge funds, a third party administrator will be responsible for valuing the fund's assets and calculating the fees payable to the manager. However, this formal segregation of duties can be compromised if the manager has a significant input into and/or influence over the administrator's valuation process. This is particularly likely where a hedge fund invests in difficult-to-value illiquid investments or complex derivatives, and the administrator lacks confidence in its capabilities in that area.

By contrast, other hedge funds choose to have valuations performed by specialist in-house functions. Reasons for doing so include the timeliness of the valuation process, the complexity of the assets and investments in the fund's portfolio or other commercial considerations.

Since in either case it is possible for the hedge fund manager to exercise influence over the valuation process, potential conflicts of interests between the hedge fund manager and investors could arise. It is therefore vital that such potential conflicts of interest are adequately managed.

The HFWG has identified the following issues concerning the separation of responsibility for valuing a fund's assets from the portfolio management function:

- Do hedge fund managers adequately mitigate potential conflicts of interest when they are involved in assisting a third party administrator in valuing the fund's assets or when valuations are performed in-house?
- Do investors understand how the valuation process is conducted?
- Are sufficient safeguards in place to ensure that valuation policies are applied consistently?

⁹ High quality materials on valuation principles have also been created by others, including AIMA and IOSCO. The AIMA Guide to Sound Practice for Hedge fund Valuation and IOSCO's Principles for the Valuation of Hedge Fund Portfolios (consultation report 03/2007) provide further detailing of specific valuation themes and HFWG recommends both as further guidance for hedge fund managers in formulating their valuation approach. Links: <http://www.aima.org/uploads/ExecSummaryAIMAGuideSPforHFValuation2007.pdf> (the full copy is only available as hard copy), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD240.pdf>

3.1.2. FSA Principles

Relevant FSA Principles in this context include:

- (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
- (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 with them in a way which is clear, fair and not misleading.

3.1.3. Best practice standards and guidance – Governance

- **A hedge fund manager should seek to ensure that conflicts of interest over asset valuation are avoided by arranging for the fund to appoint an independent third party valuation agent and/or (where agreed with the fund governing body) by operating a segregated independent in-house valuation function.**

The fund’s administrator will often be responsible for calculating the fund’s net asset value and, based on such calculation, the fees and expenses payable to the manager. Where the fund’s administrator is unable to perform this function or where the manager is involved in the valuation process because of its role in assisting the administrator, the manager should ensure that the relevant employees operate independently of the portfolio management team and are not remunerated according to the value of, or increase in the value of, the fund’s portfolio.

- **Hedge fund managers should assist fund governing bodies to satisfy themselves regularly that in-house valuations are handled adequately.**

Suggestions for how this could be achieved include:

- Ensuring that valuation staff report periodically to the fund governing body
- Ensuring that the fund governing body forms a designated “valuation committee” and that no member of such committee is involved in investment decisions
- Employing the services of an appropriate internal or external party to evaluate the effectiveness and robustness of the valuation procedures in place and report to the fund governing body (or its valuation committee)

- **Information provided by the portfolio management team for the valuation process should be properly documented and recorded.**

3.1.4. Best practice standards and guidance – Disclosure

- **Hedge fund managers, in consultation with fund governing bodies, should prepare a document (a “Valuation Policy Document”) covering all aspects of the valuation process and valuation procedures and controls. The Valuation Policy Document (which it is acknowledged will contain information which is proprietary to hedge fund managers) should be reviewed regularly by hedge fund managers, in consultation with fund governing bodies, and be made available to investors upon request on a confidential basis.**

As a minimum, the Valuation Policy Document should describe:

- The responsibilities of each of the parties involved in the valuation process
 - The processes and procedures in place to ensure conflicts of interest are managed effectively
 - The provisions of any service level agreements (SLA) entered into with third parties responsible for or involved in the valuation process (excluding details of commercial aspects of the SLA)
 - The controls and monitoring processes in place to ensure that the performance of any third party to whom the valuation function is outsourced is satisfactory
- **Hedge fund managers should disclose in the fund’s marketing materials the expected level of involvement of the portfolio management team in the valuation process and regularly report to investors on the actual level of such involvement (for example, via the fund’s annual reports or newsletters) and the reasoning for such involvement.**

This could be satisfied by disclosing an estimate of the percentage of the fund’s assets which have been, or are expected to be, valued with some input from the portfolio management team or a description of components of the portfolio, for which the portfolio management team usually makes a contribution to the valuation process.

3.1.5. Consultation questions

- *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?*

3.2. Difficult-to-value assets

3.2.1. Background

In addition to the issues identified above in relation to the separation of responsibility for valuing a fund’s assets from the portfolio management function, particular issues arise where a fund invests in illiquid or other difficult-to-value assets and investments such as special situation investments and complex derivatives.

While market prices for exchange-traded instruments are usually obtainable from exchanges or

recognised data vendors, complex assets are often valued according to broker quotes or pricing models (see separate box on pricing models) since market prices are not readily available.¹⁰

In addition, some hedge funds invest in illiquid assets, including shares in companies which are privately owned or are being prepared for initial public offerings (“IPOs”). Such investments may be held with the intention of keeping them for a period of years until an “event” such as a third party sale, IPO or liquidation of the asset occurs. Since the asset is privately held, it is likely that no trading or market price will be available until the anticipated trigger event occurs. One approach that hedge fund managers commonly employ is to place such assets in “side pockets” (see box below).

As noted in the previous section, it is essential to investors that asset valuation accurately reflects “fair value”¹¹ for all assets. Given that illiquid assets may give rise to particular difficulties, it is important that the relevant valuation processes employed should ensure fair, consistent and dependable pricing. In addition, the difficulties which arise with subscriptions and redemptions in funds with significant amounts of illiquid assets should be properly managed.

The HFWG has identified the following issues in relation to the valuation of illiquid or other difficult-to-value investments:

- Do hedge fund managers adequately manage challenges arising in valuing illiquid or other difficult-to-value assets where reliable market data is not available?
- Do hedge fund managers ensure that such assets are valued consistently?
- Do hedge fund managers provide sufficient information to investors to enable them to understand how such assets are valued?

Side box: Side-pockets

As noted above, where a hedge fund invests in illiquid assets with the intention of keeping them for a period of years until an “event” such as a third party sale, IPO or liquidation of the asset occurs, it is likely that there will be no trading and no market price available until the anticipated trigger event occurs. As a result, difficulties arise when investors subscribe for, or redeem investments in, hedge funds which are holding illiquid assets.

On the one hand, if the illiquid asset is accounted for at cost¹², an investor redeeming its investment in a fund just before the “event” would not share in a potential rise in value caused by that event. On the other hand, investors subscribing to the fund just prior to such event would benefit in an unwarranted manner from the sudden valuation uplift. Even if valuation models or third party estimations were employed to value these illiquid assets while held, this would not guarantee fair treatment of investors since the realised value may still differ significantly from the estimates.

A common approach designed to overcome this is to place illiquid investments of this type into “side pockets” such that only investors in the fund at the time at which the relevant asset is acquired will participate in any investment gains or losses attributable to that asset. Side pockets thereby help to overcome valuation difficulties arising from longer-term illiquid investments and allow fair treatment of investors.

¹⁰ It is important to bear in mind that the valuation of exchange traded positions can also be subject to uncertainty, particularly if they are large, because a recent price published by an exchange may be very different from the price at which the investment could be liquidated. Ideally, all of these liquidity-related concerns should be considered together.

¹¹ In other words, the current amount at which an asset could be exchanged between knowledgeable willing parties in an arm's length transaction. More detail on fair value can be found in AIMA's Guide to Sound Practices for Hedge Fund Valuation (04/2007), Appendix 4 (Fair Value Accounting Guidelines). The HFWG is aware of the current debate on the merits of fair value versus mark-to-model, which applies as much to banks as to the hedge fund industry.

¹² May be subject to regional accounting standards.

Side box: Pricing models

Hedge fund managers use pricing models to estimate the current fair value of many hard to price securities and instruments, which are not continuously traded and for which no current market price is available. Their use, particularly for valuing derivative positions, is common at banks and other financial institutions. The models are usually developed by third party software vendors or internally by hedge fund managers or their trading counterparts.

Such models usually attempt to estimate asset prices based on factors which have been observed to drive valuations in the past. This calibration, based on historical data, can be a limitation on pricing models. Factors that have strongly affected prices in the past might not be the same factors driving prices in the future. Therefore, reliability of the model needs to be tested regularly against observed market prices.

When considering the quality of pricing models for valuation, it is important to distinguish between, on the one hand, vanilla derivatives (such as equity swaps) which can be valued by standard off-the-shelf software models and, on the other hand, complex, structured, one-off contracts for which valuation is more difficult.

It is important that hedge fund managers put in place processes for governing pricing models, including handling of overrides to model inputs or results (see best practice standards and guidance below).

3.2.2. FSA Principles

Relevant FSA Principles include:

- (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.
- (6) Customers' interests – a firm must pay due regard to the interests of its customers and treat them fairly.

3.2.3. Best practice standards and guidance – Governance

- **Hedge fund managers should ensure that the Valuation Policy Document sets out valuation procedures for illiquid and other difficult-to-value assets and investments which are intended to ensure a consistent and dependable approach to determining fair value.**

The valuation procedures relating to illiquid and other difficult-to-value assets should be discussed and agreed with the fund governing body (or its valuation committee).

The Valuation Policy Document should include details of the hierarchy of pricing sources and models to be used for each asset type in a fund's portfolio.

- **When using broker quotes, hedge fund managers should:**
 - Make reasonable efforts to identify and draw upon multiple price sources (where available)
 - Specify in the Valuation Policy Document the acceptable tolerance ranges when multiple pricing sources are used and the approach to handling outliers
 - Ensure consistency and avoid “cherry picking” of favourable price sources by using the same brokers at each valuation point
- **When using pricing models hedge fund managers should:**
 - Have a process for approving pricing models, including back-testing, documentation and approval by the fund governing body or its valuation committee
 - Have a process for monitoring and verification against observed market prices
 - Have a process for governing manual overrides of the model inputs or results, including approval, documentation and reporting to the fund governing body or its valuation committee
- **When using side pockets, hedge fund managers should:**
 - Describe the side pocketing process in the Valuation Policy Document and in the fund’s marketing materials
 - Ensure that the fund governing body has been consulted about, and consented to, the use of side pockets
 - Ensure that side-pocketing occurs at the time of purchase of the relevant asset(s) with the initial valuation at cost ¹³
 - Ensure that the total amount of assets to be side-pocketed should be limited to what has been stated in the fund’s marketing materials
 - Ensure that management fees for the side pocketed assets are calculated on the lower of cost or market value
 - Ensure that incentive or performance fees are not charged for side-pocketed assets until a gain or loss is realised

¹³ May be subject to regional accounting standards.

3.2.4. Best practice standards and guidance – Disclosure

- Hedge fund managers should disclose (for example, via the fund’s annual report or newsletters) the extent to which internal pricing models or assumptions are used (and not drawn from externally available, authoritative sources) to value certain components of a fund’s portfolio and, where meaningful and applicable, disclose the percentage of the fund’s net asset value which has been determined using pricing models.
- Hedge fund managers should disclose (for example, via the fund’s annual report or newsletters) the proportion of the portfolio that is hard to value (for example the percentage of the portfolio which consists of unquoted or difficult-to-value securities; other measures might apply when derivatives are used).
- Hedge fund managers should ensure periodic reporting of side pockets’ value in the fund’s audited annual accounts (usually at cost, unless a market price has been observed)¹⁴.

3.2.5. Consultation question

- *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?*

¹⁴ May be subject to regional accounting standards.

4. Prudential and Risk issues

Understanding, managing, taking and controlling risk is the essence of the hedge fund business and lies at the core of FSA Principles 1 (integrity), 3 (management and control) and 4 (financial prudence). The risks taken by hedge fund managers affect a wide variety of stakeholders, including investors, prime brokers/lenders and the managers themselves, and are also important for financial stability. Therefore, assuring investors, supervisors and hedge fund counterparties that managers have a responsible approach to risk is essential to maintaining confidence in the sector.

It is important to note, however, that failure and poor performance will occur, and no risk management approach or system can or should be expected to prevent failure and poor performance.

The following sections of this report set out the HFWG's proposed risk management best practices, which are about managers establishing the following:

- A risk framework, helping managers to think about risk in a structured manner (4.1).
- Standards covering management of
 - Portfolio risk (4.2)
 - Operational risk (4.3)
 - Outsourcing risk (4.4)

4.1. Risk Framework

Given the complexity and breadth of risk issues, firms should think about risk in the context of a risk framework. The framework should cover governance aspects and all significant categories of risk, thereby providing a structure for consistently evaluating and managing risk.

The issue that the HFWG seeks to address is:

- Do hedge fund managers have a consistent risk management framework and can they adequately explain their approach to risk management?

4.1.1. FSA Principles

- (1) Integrity – a firm must conduct business with integrity.
- (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.
- (6) Customers' interests – a firm must pay due regard to the interests of its customers and treat them fairly.

4.1.2. Best practice standards and guidelines – Governance¹⁵

- Hedge fund managers should put in place a risk framework, which sets out the governance structure for their risk management activities and specifies the respective reporting lines, responsibilities and control mechanisms intended to ensure risks remain within the fund’s stated risk appetite.
- The framework should cover all relevant categories of risk, such as portfolio, operational and outsourcing risks.

4.1.3. Best practice standards and guidelines – Disclosure

- Hedge fund managers should explain their approach to managing risk (risk framework) to investors in the fund’s marketing materials.

The following table provides an overview of the different risk categories covered by the framework and where best practice is detailed in the subsequent sections.

Risk category overview

Category	Description	Risk for whom	Covered in section
Portfolio risks	Risk of losses in the investment portfolio	Direct risk for investors and creditors, indirect (reputational) risk for the manager	4.2
Operational risks	Risk of breakdowns in internal controls or systems which can lead to financial losses	Direct risk for the manager, indirect risk for investors and others	4.3
Outsourcing risks	Risk of failures in the delivery of services by third parties	Direct risk for the manager, indirect risk for investors and others	4.4

4.1.4. Consultation question

- *Are there other aspects of the proposed risk framework which are not laid out in the practices which should be considered?*

4.2. Portfolio Risk

4.2.1. Background

Investors should be assured that the fund’s risk taking is in line with the stated risk appetite, as set out in the fund’s offering documents/marketing materials.

The HFWG has identified the following issues on portfolio risk:

- Do hedge fund managers adequately monitor portfolio risks to ensure alignment with stated risk appetite?

¹⁵ MFA’s 2005 Sound Practices for Hedge Fund Managers provides further detailing of risk monitoring practices for hedge fund managers. Risk frameworks and the concept of risk appetite are common in the banking industry, as described in ‘The new Finance and Risk agenda, What is your risk appetite?’ (Oliver Wyman) http://www.oliverwyman.com/ow/pdf_files/the_new_FnR_agenda_FNR_0307.pdf.

- Do hedge fund managers sufficiently disclose the risk profile of the funds in the marketing materials so that investors can fully understand and distinguish the risk profiles of different funds?
- Do hedge fund managers provide ongoing disclosure to investors as to the fund's risk taking?

The section below provides best practice standards and guidelines relating to the following areas of portfolio risk management:

1. **Governance (Section 4.2.3.):** Adequate governance of the risk function to ensure that potential conflicts of interest between the hedge fund manager and the investor are properly mitigated.
2. **Measurement (Section 4.2.4.):** Adequate measurement of the different sources of portfolio risk.
3. **Control (Section 4.2.5.):** Monitoring processes to ensure the portfolio remains within stated boundaries.
4. **Investor disclosure (Section 4.2.6.):** Assuring investors that risk taking is in line with the stated risk appetite.

Others have also developed high quality materials on portfolio risk management, including AIMA¹⁶, MFA¹⁷ and the Risk Standards Working Group¹⁸. The HFWG recommends these documents as further guidance for hedge fund managers in developing and enhancing their approach to portfolio risk management.

4.2.2. FSA Principles

- (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.
- (10) Clients' assets – a firm must arrange adequate protection for clients' assets when it is responsible for them.

For disclosure:

- (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.
- (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.

¹⁶ Alternative Investment Management Association: Sound Practices for European Hedge Fund Managers (2007), <http://www.aima.org/uploads/GuidetoSoundPracticesforEuropeanHFMMay2007.pdf>

¹⁷ Managed Fund Association: MFA's 2005 Sound Practices for Hedge Fund Managers, <http://www.managedfunds.org/downloads/MFA%202005%20Sound%20Practices.pdf>

¹⁸ Risk Standards Working Group: Risk Standards for Institutional Investment Managers and Institutional Investors, <http://www.cmra.com/risk.pdf>

4.2.3. Best practice standards and guidelines – Governance¹⁹

- **Hedge fund managers and the fund governing body should ensure that adequate risk management systems and resources are available and well understood by portfolio managers, traders, risk managers, senior staff and other staff related to the management of the portfolio.**
- **Potential conflicts of interests in the risk monitoring process should be managed by clearly separating the risk monitoring function from portfolio management. Risk monitoring reports should be made to the person or body which has ultimate responsibility for risk management (such as the manager’s chief investment officer, chief executive officer or management committee).**
- **Hedge fund managers should put in place a written Risk Policy Document, which is approved by the fund governing body. This document should set out the responsibilities of the risk monitoring function.**

As a minimum, this should include:

- Guidelines for distribution of risk mandates among individual sub-portfolio managers and the setting and changing of risk limits
- Routines for risk reporting, exceptions reporting and escalation procedures
- Routines for reviewing and testing the risk measurement framework
- Guidelines for risk monitoring and risk measurement during stressed periods
- Routines for communicating the above information to all relevant persons within the fund manager in a clear and understandable manner

4.2.4. Best practice standards and guidelines – Measurement

Risk measurement is a complex area involving the use of sometimes standardised risk indicators, which provide comfort if they are within the boundaries of the stated risk limits. Although a measure such as Value-at-Risk (“VaR”) can be of real value in controlling certain risks, it can also provide false comfort if it is used inappropriately, adding a degree of risk which is neither foreseen, nor acceptable, within the fund’s risk appetite.

Risk measurement therefore requires a sound understanding of the dynamics and the nature of risks in the portfolio (both in normal as well as stressed market conditions) before selecting appropriate and coherent risk measures to control them. Given the breadth of hedge fund strategies and emerging new risk profiles within the sector, there is no single risk measure appropriate in all circumstances and it would be unwise to rely on just one measure without supplementing it with other risk analyses and with allowing human intervention the last word.

The following sections provide an overview on best practice principles for measuring **funding liquidity, market** and **counterparty** risk.

¹⁹ Further guidance can be found in AIMA’s Guide to Sound Practice for European Hedge Fund Managers, 2007, 2.1.2.

4.2.4.1. Funding liquidity risk

A hedge fund needs cash to invest, meet investor redemptions and margin calls, and to pay creditors and expenses. The sources of liquidity are available cash, fund subscriptions, liquid assets that can be sold quickly and credit lines with prime brokers and other lenders. Funding liquidity risk refers to the risk of a fund not being able at all times to meet its obligations to creditors, counterparties or investors.

The leveraged²⁰ nature of many hedge funds may make their cash position more sensitive to sudden market distress than that of classic mutual funds. The complexity arises when, for example, unexpected falls in market prices trigger sudden margin calls, which have to be met by asset liquidations by the fund (which in turn might cause asset prices to drop). Hedge fund managers should therefore be constantly vigilant measuring and managing liquidity risks.

Best practice standards and guidelines

- **Hedge fund managers should have a liquidity management framework, the primary role of which is to ensure that the liquidity profile of the fund's investments aligns with the fund's financial obligations.**

This should include forecasting the liquidity position of the fund and tracking liquidity measures (for example, ratios such as "available cash/Value-at-Risk") which allow the hedge fund manager to assess the probable development of the liquidity position relative to the portfolio's inherent risk.

- **Hedge fund managers should frequently conduct stress testing and scenario analysis of the fund's liquidity position.**

Potential stress events could include:

- Margin calls due to sudden severe market shocks (for example, significant equity price falls)
- Reduction in liquidity in certain market segments relevant to the fund
- Sudden increase in collateral requirements for funding positions (thereby reducing assets available for sale to meet liquidity needs)
- Investor redemptions (as per the fund's redemption policies)
- Cancellation of credit lines (as per notice periods agreed between the hedge fund manager and counterparties such as prime brokers)

- **The stress testing/scenario analyses of the fund's liquidity position should work with similar approaches to market risk (see subsequent section).**

It has been widely found that in stress situations unexpected correlation can appear. Hedge funds have been faced with sudden liquidation challenges due in part or in whole to rapid market movements, for example in currencies, commodities or equities. So reviewing these analytics in parallel is critical to a fund having an effective approach to risk management.

²⁰ Leverage is explained in Appendix B.

4.2.4.2. Market risk

Market risk refers to the risk of losses to the portfolio due to fluctuations in, for example, interest rates, equities and commodity prices and foreign exchange rates. It also includes factors such as volatility risk²¹ and correlation risk²².

Best practice standards and guidelines

- **A hedge fund manager should develop a comprehensive set of measures to identify market risk in the fund's portfolio. To overcome the shortcomings of individual measures, managers should rely on multiple techniques. These could include, amongst others:**
 - Volatility measures
 - Value-at-Risk type approaches
 - Monte Carlo simulation²³
 - Stress tests/scenario analyses²⁴
 - Leverage
 - Portfolio concentration measures
- **Hedge fund managers should conduct stress testing/scenario analyses to assess the impact of extreme market occurrences on the portfolio value.**

Extreme financial events may not receive sufficient attention when using classic risk measures such as volatility and Value-at-Risk due to the scarcity of historical observations for extreme financial events. Stress testing/scenario analysis allows managers to overcome this shortcoming by accounting for the increased inter-correlation between different asset classes at times of market turmoil.²⁵

Stresses could include, among other things, equity price drops, sudden shifts of interest rate curves and abrupt changes in foreign exchange rates. A scenario analysis would combine several of these "stresses" across markets at the same time based on extreme assumptions about correlations which may not occur in normal markets.

The analysis should include scenarios based on historically observed crises (for example, the bursting of the new economy bubble in 2000 or the sub-prime mortgage crisis in 2007) and newly developed ("made-up") scenarios to incorporate emerging correlations and new risks, and their respective impacts on the portfolio.

Hedge fund managers should also assess basis risk arising from imperfect hedging strategies²⁶ and incorporate resultant uncertainties into their stress testing/scenario analysis approach.

- **Hedge fund managers should account for valuation sensitivities under stressed conditions in their approach to risk measurement (for example, Value-at-Risk, stress testing/scenario analysis).**

21 Volatility risk: the risk of a change in the (expected) volatility of a price of an asset (which could for example affect option prices).

22 Correlation risk: the risk of change in the (expected) correlation between asset prices.

23 Monte Carlo simulation: statistical evaluation of risks, where a large number of "scenarios" is generated based on random samples for uncertain underlying variables.

24 A stress test simulates a significant market move (eg 30% equity price drop) and measures the impact on the fund's value. In a scenario analysis, multiple stresses are applied simultaneously (eg 30% equity price drop, shift in interest rates, etc).

25 Also sometimes referred to as "fat tails", which means that extreme occurrences are more likely to occur than theoretically expected.

26 For example, when the price of a future varies from the price of the underlying instrument as expiry approaches. The imperfection of hedging strategies is likely to be higher the more immature the market.

In times of abrupt market fluctuations, situations can arise where market liquidity is much lower than is usually observed, making it difficult to trade positions at observed market prices. Under such circumstances, a fund's net asset value may not only be hard to calculate, but be unattainable in the event sales are attempted. At the same time, the manager might be forced to sell positions, for example in order to meet redemption requests and/or margin calls. The risk measurement framework should account for this by applying valuation discounts for modelling purposes to positions that might have to be liquidated under stressed conditions (see Section 4.2.4.1 (*Funding liquidity risk*)).

- **The results of the analysis of market risks (stress tests/scenario analyses, etc) should be translated into timely management action (for example, adjustment of positions) as part of the control and management process.**

Side box: Misleading or inappropriate risk measures

Misleading risk measures: AAA-rated mortgage derivatives in 2007

In early 2007 problems emerged in the sub-prime mortgage market causing sharp falls in the prices of collateralised debt obligations (CDOs) and other related derivatives underpinned by mortgage repayments. The lowest rated derivatives, linked to the first losses incurred from mortgage defaults, fell in price first. But subsequently, even the highest rated derivatives such as AAA-rated CDOs also experienced sharp price drops – up to 10% in a few days.²⁷

Such price volatility is not usually associated with AAA-rated derivatives, and may have reflected liquidity issues and hedging-driven trading as opposed to a repricing based on a revision of fundamental value. Investors who had bought such instruments on the basis of their rating were probably surprised. But without such ratings, an investor using normal risk measures would have found it difficult to assess the risk such instruments posed. Historical VaR measures would have offered little guidance because for some types of the derivatives there was little historical experience to draw on, and where histories did exist they had been generated in a benign macroeconomic environment. Scenario analysis and stress testing – seeing how the instruments might be expected to behave in a less benign economic environment – might have revealed more information. This shows that scenario and stress frameworks should also strive to capture market dynamics such as forced selling (for example because of losses incurred on lower-rated derivatives) and volatility of liquidity premiums.

4.2.4.3. Counterparty credit risk

Hedge fund managers enter transactions with various trading counterparties, including, among others, prime brokers, lending banks and exchanges. Counterparty credit risk refers to the risk of loss due to a trading counterparty defaulting on its obligations. This risk is particularly relevant to derivative positions, where the exposure between counterparties fluctuates over the life of the contract. Hedge fund managers practising best practice will implement a spectrum of measures to monitor and contain counterparty credit risks to acceptable levels, as set out in the following best practice standards and guidance.²⁸

²⁷ Eg, over the month of July 2007 the ABX AAA 07-01 index dropped in price from 99.5 to 88.

²⁸ Further detail has been provided by the Counterparty Risk Management Policy Group II (2005), *Towards Greater Financial Stability: A Private Sector Perspective (07/2005)*, section III (Improving Transparency and Counterparty Credit Assessments), <http://www.crmgroup.org>. See also MFA's 2005 Sound Practices for Hedge Fund Managers (4.9).

Best practice standards and guidance

- **Hedge fund managers should have a formalised process for setting up trading relationships, including assessment of creditworthiness and setting of risk limits.**
- **Creditworthiness of trading counterparties should be monitored continuously and risk limits adjusted if required.**
- **Netting agreements and collateral arrangements (for example, hedge fund managers making collateral calls/two-way collateral posting) should be put in place.**

4.2.5. Best practice standard and guidelines – Control process

There is little point in having sophisticated risk measurement methodologies unless the results are translated into management action if breaches of risk limits occur.

- **Hedge fund managers should track a fund's adherence to its stated investment objectives and risk appetite and, subject to override by the manager's chief executive officer, chief investment officer, management committee or similar, take corrective action if a breach of any restrictions or limits occurs.**

Limits should be set at the outset for the aggregate portfolio and all individual sub-portfolios. These limits should include general investment restrictions (for example, eligible asset classes, geographic location of risk) and could also encompass individual limits for market risk, funding liquidity risk, counterparty credit risk and other relevant risk factors such as concentrations (for example, in relation to single names, sectors or illiquid assets).

Risk reporting should be put in place so that the investment decision makers have a daily or more frequent view of the risk position of the fund and can prevent breaches of limits. Limit breaches should be immediately reported to the respective fund manager, the manager of the trading activity and the compliance officer, with escalation as needed to the fund manager's chief executive officer, chief investment officer, management committee or similar. Serious breaches should be reported immediately to the fund governing body.

The process should ensure that, if required, the findings of the stress testing/scenario analyses are translated into mitigating portfolio risks.

4.2.6. Best practice standard and guidelines – Disclosure (to investors)

- **Hedge fund managers need make the necessary effort to disclosing and explaining their investment and risk management approach in the fund's offering documents.**

As a minimum this should include all items described in section 2.1 (*Investment policy and risk disclosure*) together with a summary of the risk framework (processes and risk management techniques employed, and reporting lines). Hedge fund managers should also carefully consider whether it would be appropriate to disclose target ranges or averages as anticipated by the manager for specific risk parameters. This could include:

- Volatility of returns

- Value-at-risk or equivalent (for example, potential loss arising from a stress event)
 - Leverage (the manager would need to clarify how leverage is defined)²⁹
 - Limits to the percentage of the portfolio which can be invested in non-marketable securities³⁰ (or another measure of liquidity)
 - **The hedge fund manager should then ensure that the management report submitted with the audited annual accounts of each hedge fund includes disclosures on the risk profile of the fund for the respective period.**
- As a minimum, this should include:
- The actual risk profile of the fund, where applicable using risk measures such as
 - Realised volatility of returns
 - Value-at-Risk type measures (actual, average, range for observation period and decomposed by, for example, risk type and market)
 - Leverage (high, low, average for the respective observation period), if applicable
 - The percentage of the portfolio invested in non-marketable securities (or other measures of liquidity)
 - Investment instruments used during the respective period

4.3. Operational Risk

4.3.1. Background

Managing and mitigating operational risks is important for a sound approach to risk management by hedge fund managers. Operational risk includes breakdowns in internal controls, systems and corporate governance and unexpected disasters which can lead to financial losses from failure to perform, error and fraud.

Guidance on operational sound practices for hedge fund managers can fill many manuals and goes beyond the scope of this report, but there are several areas where the HFWG considers compliance with best practices to be particularly important:³¹

- People and governance
- Trading and execution
- Fraud and financial crime prevention
- Disaster recovery
- IT systems
- Model risks

²⁹ See Appendix B for leverage definition.

³⁰ Marketable Securities: Securities, that can be easily liquidated into cash, for example government securities, stock, bonds, notes, commercial paper, and other financial instruments that are regularly listed for sale on recognized public exchanges.

³¹ The Basel Committee on Banking Supervision has produced valuable material on sound practices for managing operational risk in the banking industry (eg <http://www.bis.org/publ/bcbs96.pdf>). Further materials have been produced by industry bodies such as, eg, AIMA and MFA and are deliberately highlighted below.

4.3.2. FSA Principles

- (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.
- (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.
- (10) Clients' assets – a firm must arrange adequate protection for clients' assets when it is responsible for them.

4.3.3. Best practice standards and guidance – Governance

4.3.3.1. People and Governance

- **In areas where potential conflicts of interest could arise (valuation, risk management, compliance), hedge fund managers should clearly divide these activities from the portfolio management function with separate reporting lines into the managers' chief executive officer or chief investment officer or similar.**

The HFWG acknowledges that separation of duties may not always be possible for start-up and smaller hedge fund managers. Hedge fund managers should disclose to investors if they have not adequately separated (or are unable adequately to segregate) activities in areas such as valuation, risk management and compliance and explain how they intend to deal with the issues which may arise as a result.

- **Staff remuneration should not set false incentives (for example, aligning the compensation of the valuation team with fund performance).**
- **The hedge fund manager should ensure that material aspects of its operational procedures are adequately documented and training is provided to staff. This should include, among others, areas such as compliance procedures, back-up/disaster recovery procedures, personal account dealing policies and client confidentiality. (See Part 1 of the report, Section 6 (*Longer term and next steps*) for a proposal on developing an educational curriculum dedicated to the hedge fund sector).**

4.3.3.2. Trading and execution

Hedge funds are exposed to trading-related risks, including failed trades, price overrides and trade confirmation backlogs, which could ultimately expose the fund to market, credit and liquidity risks. These operational issues are not particular to hedge fund managers, but also affect banks and long-only asset managers.³²

³² Further guidance on sound practices for transactional practices can be found in AIMA's Guide to Sound Practices for European Hedge Fund Managers, 2007, sections 3.3 and 3.4; and MFA's 2005 Sound Practices for Hedge Fund Managers (section VI).

- **To prevent trading and execution failures, it is considered best practice to have effective trading and counterparty procedures in place, incorporating the following aspects:**
 - **Master agreements for trading counterparties**
 - **Well defined termination and collateral policies**
 - **Tracking of changes in key provisions**
 - **Robust trade confirmation and reconciliation process**
 - **Sufficient back- and middle-office capacity to handle trading volumes**
 - **Daily confirmation of trades and positions**
 - **Use of electronic matching and confirmation systems**
 - **Timely reconciliation of complex OTC trades and loans**
 - **Monitoring of corporate action events (for example, voting, splits, spin-offs) on long and short equity derivative instruments and applying the events to fund accounts**

Side box: Documentation issues

There are numerous illustrations where the interplay of legal and documentation risks surface between hedge funds and the broker dealer, investor and regulatory community. Indeed the foundation of much of the credit and counterparty and investor risks which are apparent in the market come to bear in the somewhat more remote and less understood world of the legal agreements that surround them. Several years ago the industry broadly agreed that assignment of contracts in the credit derivative markets had become unnecessarily risky and needed redress. For years, the industry had been beset by a high percentage of assignments which had been poorly documented between dealers and end user counterparties involving credit derivative transactions. The NY Federal Reserve, assisted by FSA, intervened and, with the major dealers, identified the key triggers and drivers surrounding this topic. The Counterparty Risk Management Group (CRMPG) then set out a series of recommendations that quickly found their way into a Protocol of agreements between large broker dealers and hedge funds globally, vastly reducing the number of undocumented and unsigned assignments within a short time. This set of private sector initiatives, had reversed years of increased operational and legal risks and restored much needed stability to the market.

Indeed there are a series of issues relating to legal risk where documentation plays a very important role. Hedge Funds and their dealer and investor colleagues interact with one another on a series of topics including:

- A. Enforceability of master netting agreements across legal jurisdictions
- B. Trigger mechanisms as to what determines a default action in a master agreement based upon insufficient NAV

C. Language on margin lock ups and terms and conditions of those time frames

It is important that funds and dealers continually strive to achieve best practice in the field of documentation and legal compliance since the ability to ensure broad enforceability of their documents is critical to their success and how their professionalism is viewed in the marketplace.

4.3.3.3. Fraud and financial crime prevention

Financial crime and fraud pose a serious threat to individual firms and can undermine the integrity of the financial services sector and markets as a whole.³³

- **Hedge fund managers should be confident that they themselves understand the applicable laws and regulations in the markets where they deal and have adequate procedures to prevent financial crimes. This applies to areas such as:**
 - **Anti-money laundering procedures³⁴**
 - **Procedures to prevent market abuse offences see Section 6.1 (*Prevention of market abuse*)**
 - **Strict internal controls to prevent misappropriation of client monies**
- **Hedge fund managers who adhere to best practice will appoint an independent compliance officer, overseeing all issues relating to legal and regulatory compliance, market and professional conduct, with regular reporting to the manager's chief executive officer or management committee or equivalent and the fund governing body.**

4.3.3.4. Disaster recovery

Various internal and external events such as building fire, terrorism or avian flu could interrupt operations in the absence of disaster recovery and business continuity plans being created and tested.³⁵

- **Hedge fund managers should ensure that the provision of fund management services will remain possible in the event of a disaster. The level of tolerance should be agreed by the executive committee of the hedge fund manager, or, where relevant fund governing body. Depending on the scale of the hedge fund manager's business, this should include:**
 - **A communication plan to contact important parties (such as senior management, prime broker, administrator and supervisor)**
 - **Contingency plans (including succession plan to address key man risk, fall back communications router and capabilities)**
 - **Offsite data back-up facilities**
 - **Back-up office space/infrastructure**
 - **Regular testing of procedures/processes**

33 Further references: FSA handbook (eg SYSC 3.2) <http://fsahandbook.info/FSA/html/handbook/SYSC/3/2/>, FSA website: http://www.fsa.gov.uk/Pages/About/What/financial_crime/money_laundering/index.shtml. Detailed information on prevention of money laundering is also provided by the Joint Money Laundering Steering Group (JMLSG), www.jmlsg.org.uk

34 Further guidance on Anti-Money Laundering Regulations can be found in AIMA's Guide to Sound Practices for European Hedge Fund Managers (2007), (section 4.1.5).

35 Further guidance on sound practices for disaster recovery procedures can be found in AIMA's Guide to Sound Practices for Business Continuity Management for Hedge Fund Managers (06/2006), AIMA's Sound Practices for European Hedge Fund Managers (2007), (eg 3.9); and MFA's 2005 Sound Practices for Hedge Fund Manager (VII).

4.3.3.5. Model risk

The investment process, risk management and hedging strategies hedge fund managers pursue often depend on models which can leave them exposed to certain types of model risk. Model risk refers to the risk that arises when the models used are:

- Applied to tasks for which they are inappropriate
- Based on incorrect assumptions
- Otherwise implemented incorrectly

As a result, these models can if used inappropriately provide “false comfort” to hedge fund managers. This underlines the need for all models to be properly governed so that where necessary management exercise human judgement and override models.

The magnitude of model risk will be a function of the complexity of the hedge fund manager’s investment mandates, the nature of the assets and the range of models used. For example, a hedge fund manager focusing on exotic derivative markets where almost all trading decisions involve elements of complex evaluation models has greater exposure to this risk than an equity long/short manager that limits its use of models to company earnings simulations.

- **As part of their operational risk management procedures, hedge fund managers should assess their exposure to model risk annually and where model risk is perceived to be material to the performance of the manager, should implement appropriate procedures to ensure that material model risks are identified and mitigated where possible. Such procedures include:**
 - Evaluation of model risk in the model selection process
 - Frequent review of models, including parameterisation, calibration, assumptions and data integrity
 - Stress testing of assumptions
 - Sign-off and documentation of management overrides (overrides can become necessary when models produce unreasonable results so that human intervention becomes necessary. Human overrides need to be governed carefully)
 - Documentation of models to avoid key man risk
 - Security of algorithm and source code (back-up)
- **Hedge fund managers should disclose use of internal models in the valuation process Section 3 (Valuation).**

4.3.3.6. IT security

Like all other technologically dependent operations, hedge funds require support from systems and operations globally 24 hours a day throughout the year. As a result, measures such as secure offsite facilitation, disaster recovery and technological and systems recovery are essential.³⁶

³⁶ Further guidance on sound practices on IT security can be found in AIMA’s Guide to Sound Practice for European Hedge Fund Managers (2007), (section 3.9) and AIMA’s Guide to Sound Practices for Business Continuity Management for Hedge Fund Managers (06/2006).

- **Hedge fund managers should ensure security and integrity of systems and data. This includes system testing, offsite back-up facilities, disaster recovery procedures and supervision of contract IT resources.**

4.3.4. Best practice standards and guidelines – Disclosure

- **To ensure that investors and creditors are confident that hedge fund managers handle operational risks satisfactorily, a summary of management procedures and controls applying to the management of operational risk should be available to investors and creditors undertaking due diligence.**

4.4. Outsourcing risks

4.4.1. Background

The hedge fund industry is traditionally based on a strongly unbundled business model, with managers focussing on what they are best at – managing the portfolio – while third parties provide other services such as:

- An administrator to handle, amongst other things, fund accounting and transfer agency services (for example, handling subscriptions for and redemptions of investments in the funds)
- A valuation expert (often also the administrator) to value the assets and investments in the fund's portfolio
- One or more prime brokers to provide, amongst others, brokerage, stock-lending, financing, back and middle-office support (including clearing and settlement of trades) and other administrative services
- One or more custodians (often also prime brokers) to provide custody services for the fund's assets
- An auditor to provide audit services for the fund's annual accounts

All of these services are vital to the success of hedge funds. Ensuring that the selection and monitoring of third party service providers is properly managed is therefore of great importance to investors.

The HFWG has identified the following issues in relation to third party services provided to the hedge fund:

- Do hedge fund managers take sufficient care and conduct adequate due diligence when selecting third party service providers for the fund?
- Is monitoring of third party service providers by hedge fund managers adequate?
- Do hedge fund managers provide sufficient information to fund governing bodies to enable them to evaluate and review the appointment or continued appointment of third party service providers?

- Do hedge funds rely excessively on particular third party service providers who may lack robust infrastructure and fail to provide expected service levels?
- Is sufficient information provided to investors as to how third party service providers are selected and their performance monitored?

4.4.2. FSA Principles

Relevant FSA Principles include:

- (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.
- (10) Clients’ assets – a firm must arrange adequate protection for clients’ assets when it is responsible for them.

4.4.3. Best practice standards and guidance – Governance

Third party services are normally provided under a contract between the hedge fund and the entity providing the service.

- **Hedge fund managers should conduct careful due diligence on third party service providers before recommending them to the fund governing body.**
- **Hedge fund managers should assist fund governing bodies to establish policies for selection and regular review of third party providers.**

Valuation and administration

- **Hedge fund managers should seek to ensure that a service level agreement (“SLA”) is put in place (commonly, this will be attached as a schedule to the agreement between the fund and the service provider). The SLA should set out in precise detail the services to be provided along with deadlines for completion of the services.**
 - The SLA should make clear accountability and responsibilities for the orderly operation of all administration or other functions performed on behalf of investors
 - The SLA should include Key Performance Indicators (“KPIs”) to provide hedge fund managers and fund governing bodies with a means of measuring whether the objectives set out in the SLA are met by the third party service provider
 - Further guidance on the contents of SLA is provided in Appendix C
- **The services provided should be regularly reviewed by the hedge fund manager and the fund governing body against contractual or agreed standards.**

Prime brokers

- **Although prime brokers often try to provide “one-stop shop” services, it is recommended that large hedge fund managers have more than one prime broker to ensure sufficient diversification of funding and other services.**

The HFWG acknowledges that this may not be applicable to smaller hedge funds and new market entrants.

- **In carrying out due diligence, the hedge fund manager should consider the potential prime broker's credit rating and general ability to fulfil all process functions accurately and efficiently.**

Auditors

- **Fund governing bodies should appoint reputable auditors.**

4.4.4. Best practice standards – Disclosure

- **The names of the third party providers used should be disclosed to investors in the due diligence documents or upon request.**
- **Hedge fund managers should provide information on committed funding or financing arrangements with prime brokers/lenders to investors in the due diligence documents or upon request.**
- **The nature of any special commercial terms with third party service providers which result in potential conflicts of interest (for example in-house brokerage or rebates) should be disclosed in the due diligence documents or upon request.**
- **Governance procedures in relation to third party service providers should be disclosed in the due diligence documents or upon request.**

In addition to the standards set out in this report, AIMA provides further details in its Guide to Sound Practice for European Hedge Fund Managers, 2007 (chapter 3.8).

4.5. Consultation question

- *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?*

5. Fund Governance

5.1. Background

Potential conflicts of interest can arise between hedge fund managers, the hedge funds which they manage and investors in those hedge funds, for example in relation to manager remuneration and other related factors. To mitigate these potential conflicts, appropriate governance mechanisms and oversight are required.

An important issue to consider on establishing a fund, therefore, is the mechanism for addressing and containing such potential conflicts of interest. This issue was probably not very important when the hedge fund industry was in its infancy. Perhaps this reflects the fact that the relationships between managers and their relatively few private investors were more informal and managers themselves may have been the main investors. These relationships were essentially based on mutual knowledge and trust. As the industry has grown, however, the investor base has broadened with more and more institutional investors (insurance companies, pension funds, endowments and so on) and funds of funds starting to invest in hedge funds. For three reasons, the HFWG considers that this change in the investor base requires a reinforcement of oversight processes:

- Increasing remoteness between ultimate investors and hedge fund managers
- Increasing institutionalisation, with investors looking for a higher degree of comfort
- Increasing “retailisation” of the ultimate investor base (for example, entry of retail investors and investment by insurance companies and pensions plans owing ultimate duties to retail investors)

Of course, not all hedge funds are the same and so best practice in any particular case may need to reflect the investor base, the size and age of a fund, how long the manager has held the position and other relevant factors. This indicates a spectrum of governance approaches:

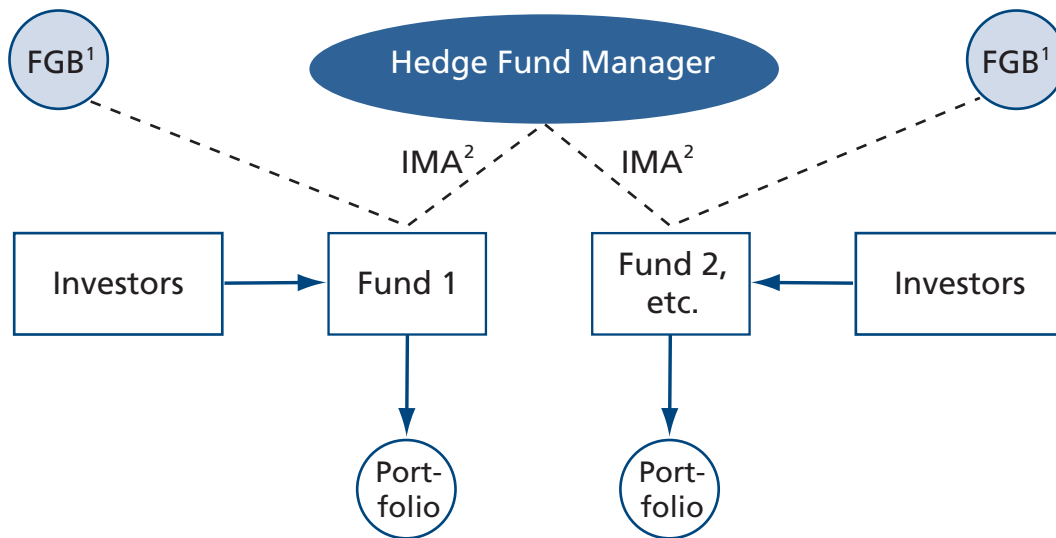
- At one end of the spectrum are the more informal types of hedge funds, where the hedge fund managers themselves are significant investors and there is a limited number of other sophisticated investors who are known to the manager. A more informal set of governance arrangements may be appropriate for these funds. It should be noted, however, that at times of stress the nature of the relationship between the manager and the fund governing body can be tested. It may therefore be the case that a more robust, advanced governance model could be an advantage even for these more informal types of hedge fund.
- At the other end of the spectrum, best practice should reflect the increased remoteness, institutionalisation and “retailisation” of the investor base by the fund manager seeking to strengthen the fund governing body and to give more prominence to the distinction and independence between it and the hedge fund manager. Such independence may be reflected in the ability of the fund governing body to terminate the investment management agreement.
- In the case of listed or quoted vehicles, this is likely to make compliance with all or substantially all of the provisions of established codes of corporate governance³⁷ desirable (or perhaps versions of such codes which have been adapted specifically for hedge funds). An advanced governance model such as this requires a suitably qualified and experienced board with a majority of independent directors who can hold the manager directly to account for its performance and its conduct under the investment management agreement.

37 Such as the AIC Code of Corporate Governance (<http://www.theaic.co.uk/files/technical/AICCode.pdf>).

Of course, the HFWG acknowledges that irrespective of the chosen governance approach, in practical terms, investors usually choose a manager to invest with rather than appointing a fund governing body with a mandate to select an appropriate manager.

- The key issue which the HFWG has identified in relation to the establishment of appropriate fund governance mechanisms is therefore: do hedge fund managers provide a satisfactory mechanism or vehicle to handle potential conflicts of interest as between themselves and investors?

Simplified illustration of typical hedge fund structure



1. Fund Governing Body
2. Investment Management Agreement

5.2. FSA Principles

Relevant FSA Principles in this context include:

- (3) Management and control – a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
- (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 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.

5.3. Best practice standards and guidance – Governance

- **On establishing a fund, hedge fund managers should assess where the fund governance structure should lie on the spectrum (see above). In light of that assessment, the manager should be proactive in ensuring that, regardless of the jurisdiction in which a fund is established, a fund governance structure which is suitable and robust to oversee and handle potential conflicts of interest is in place.**
- **Hedge fund managers should make sufficient resources available to identify and obtain members of fund governing bodies with suitable experience and integrity to enable the fund governing body to be able to discharge effectively its role with the appropriate level of independence.**
- **Hedge fund managers should throughout the life of the fund monitor whether the fund governing body and governance processes continue to be effective and appropriate (given any changes in the nature of the fund and its investors) and advise the fund governing body as to whether it considers changes to be necessary or desirable:**
 - Managers should consider whether the investment management agreement should contain an obligation on the manager to monitor the fund governance arrangements and advise the fund governing body accordingly
 - Managers should also consider whether the investment management agreement should contain an undertaking by the fund to put any new or replacement fund director proposed by the manager to an investor vote
- **Hedge fund managers should carefully consider the extent to which the adoption by the fund governing body of all or parts of established codes of corporate governance is appropriate and encourage fund governing bodies to act accordingly. This includes ensuring that fund governing bodies have adequate resources to comply with any such corporate governance principles.**

Whilst the HFWG recognises that managers cannot legally require independent boards to adopt best practice principles for their governance, they should nevertheless encourage compliance. Naturally, the HFWG is also aware that the best practice standards in no way override legal, technical, contractual and tax realities.

As guidance to managers when considering the corporate governance principles which they should encourage fund governing bodies to comply with, the HFWG has set out below a selection of those principles contained in the corporate governance codes published by AIC and AIMA which it considers to be of greatest importance³⁸. The HFWG recognises, however, that not all of these principles will be applicable to all types of hedge fund:

- Directors' potential conflicts of interest should be disclosed fully to the fund's investors (through the prospectus) and the board as a whole (at the first available meeting) (AIMA 1.D)
- Fund boards should have sufficient collective expertise, availability and be otherwise qualified to understand the investment policy and strategies of the fund and the attendant risks (AIC 6., AIMA 1.F). Expertise should include areas such as regulatory issues, accounting, administration and technical understanding of the fund's strategies

³⁸ AIC: Association of Investment Companies: The AIC Code of Corporate Governance (2007), <http://www.theaic.co.uk/files/technical/AICCode.pdf>; Alternative Investment Management Association: AIMA's Offshore Alternative Fund Director's Guide (2005), www.AIMA.org

- The board should put in place a policy on tenure of directors and disclose it in the fund’s marketing materials and its annual report (AIC 4.)
- Directors’ remuneration should reflect their duties and responsibilities, and the value of their time spent (AIC 8.)
- Regular face to face board meetings should be held, preferably quarterly (AIMA 1.F.). Typical board agendas include approval of accounts, investment performance review, review of any relevant regulatory breaches and review of the performance of third party service providers such as the administrator and prime broker(s)
- There should be regular review of adherence of the manager to investment policy and investment restrictions, review and approval of side letters, compliance and valuation functions and regular review of business continuity. (AIMA 3.E provides further detail)
- The manager, external valuation agent and administrator should be required to report regularly to the fund directors regarding performance, subscriptions, redemptions and adherence to investment policy and restrictions and applicable anti-money laundering requirements (including direct reporting from the compliance officer and any in-house valuation function) (eg AIMA 4.B. and 6.B. and 6.E.)
- The fund directors should be made aware of their personal responsibility for the issuance and legality of side letters or discretionary waivers (AIMA 6.I. and 6.K.)
- The fund on behalf of the directors should take out adequate D&O insurance proportional to any liabilities relating to their role with respect to the fund (AIMA 7.)

5.4. Best practice standards – Disclosure

- **The hedge fund manager should disclose the outcome of its assessment as to the location of the fund’s governance requirements on the “spectrum” and its reasoning in the fund’s prospectus.**
- **Where relevant, hedge fund managers should ensure that the existence of any class of shares which are held only by the manager (or an entity connected with the manager) and which carry voting rights affecting fund governance is disclosed in the fund’s prospectus.**

Such classes of shares are often known as “founder” or “management” shares and carry rights to, among other things, vote (to the exclusion of any other shareholders) on the appointment or removal of directors and/or the termination of the investment management agreement between the hedge fund and its manager.

Naturally, the HFWG recognises that in following the best practice standards set out, hedge fund managers will need to take into account any relevant legal, regulatory, accounting or tax considerations

5.5. Consultation question

- *Have we adequately covered the main issues in relation to this increasingly important area?*

6. Market issues and activism

“Activism” can be seen as encouraging alteration in behaviour by companies that could be beneficial to their shareholders. Investors who take on a more pronounced role in dealing with companies in which they are invested are often referred to as “activist” investors. This could include, but is not limited to, engaging in discussions with management on issues such as overall company strategy, capital structure, dividend policy, merger or de-merger decisions and executive compensation. It could ultimately result in the investor exercising its voting power to effect the changes that the investor believes will increase the value of its investment in the company.

While the term activism is often used to describe hedge fund managers, it is important to note that an overwhelmingly large number of activist investors are clearly not hedge fund managers, and most hedge fund managers are not pursuing activist strategies. Even if a manager is labelled as being activist, this does not mean that it engages actively with all companies in which it invests.

The HFWG acknowledges that there is a public debate on the advantages and disadvantages of activist investing. Among the perceived advantages are better risk and resource allocation in the economy as a whole and strengthened corporate governance³⁹. Perceived disadvantages include short-termism and job losses in corporate restructurings. However, general debate about activist investing is beyond the scope of this report, although the HFWG members would be happy to contribute to it. Rather than engaging in this debate within this report, the HFWG believes it is more appropriate to clarify some specific underlying concerns and delineate best practice approaches that hedge fund managers should adhere to. Relevant areas include “prevention of market abuse” such as insider trading and issues relating to shareholder conduct.

It is important to note that the best practice approaches identified in the following sections not only apply to hedge fund managers but might well merit consideration for adoption by all investors.

6.1. Prevention of market abuse

6.1.1. Background

Proper market conduct and prevention of market abuse are crucial to maintaining market integrity and overall confidence in financial markets. All market participants including hedge fund managers have to comply with the laws and regulations applicable in the markets in which they invest. In the EU context, the relevant legislation is the Market Abuse Directive (MAD) which has been implemented in the United Kingdom by section 118 of the Financial Services and Markets Act 2000 (FSMA)⁴⁰. In addition to the five market abuse offences introduced by MAD, FSMA also contains two market abuse offences retained from the pre-MAD UK regime. The Code of Market Conduct published by the FSA contains guidance on compliance with the market abuse regime.

Activist investors are much more involved in the interplay of information between the public and private domains than traditional managers and therefore need to be particularly vigilant about market abuse. In addition, hedge funds often span a variety of asset classes including equities, credit and private equity, and may have access to privileged information in certain areas of their organisation. This requires adequate mechanisms such as Chinese walls to ensure compliance with regulation.

The HFWG has identified the following issue on investment policy disclosure:

- Do hedge fund managers comply with applicable law and regulation on market abuse?

³⁹ Eg see OECD Report on “The Implications of Alternative Investment Vehicles For Corporate Governance”, July 2007, <http://www.oecd.org/dataoecd/60/11/39007051.pdf>

⁴⁰ See .Appendix D (Market abuse).

6.1.2. FSA Principles

- (1) Integrity – a firm must conduct its business with integrity.
- (3) Management and control – a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
- (5) Market conduct – a firm must observe proper standards of market conduct.
- (11) Relations with regulators – a firm must deal with its regulators in an open and co-operative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

6.1.3. Best practice standards and guidance – Governance

- **Hedge fund managers should ensure that they have internal compliance arrangements to identify, detect and prevent breaches of market abuse laws and regulations.**

A sound approach would include the following components:

- A dedicated compliance officer who is not involved in the investment management process
- Written compliance document describing all relevant compliance procedures
- Documentation of all compliance incidents by the compliance officer
- Training/education of investment management and other staff to ensure that the relevant laws and regulations, the relevant compliance procedures and what constitutes inside information are all understood and adhered to
- Direct and regular reporting of the compliance function to the fund governing body
- Seeking legal and regulatory guidance to ensure that compliance arrangements prevent regulatory breaches
- Disclosure of the name of the compliance officer to investors in the fund's marketing materials and annual accounts
- Open relations with the regulator

The table below provides some examples of procedures which may support the application of best practices:

Illustration: Compliance procedures to identify, detect and prevent market abuse

Abuse	Procedures
Insider dealing	<ul style="list-style-type: none"> • Notification to the compliance officer if an employee believes he/she has received inside information • Compliance officer to determine whether information is material and non-public • If information is material and non-public, the securities of the issuer concerned are to be placed on the restricted list (in which case such stocks cannot be traded) or on a grey list (non-disclosed restricted list, which prevents such information from being shared with the entire firm, such that it might allow personnel to second guess why something was restricted) • Securities (shares, bonds, etc) of companies on the restricted list in which the entire firm would be excluded from dealing (for example, restricted in the order management system) • Chinese walls to prevent, for example, individual portfolio managers who are members of a creditors' committee of a distressed or bankrupt company (and who therefore have access to confidential information) from also trading such company's debt or equity • In instances where inside information is known to employees who have no active involvement in the investment management function, documentation of details of this knowledge should be placed on a separate (non-publicised) register
Dissemination of insider information	<ul style="list-style-type: none"> • Managers should have policies to restrict dissemination of material non-public information including, for example, the manager's own intention actively to engage with a company (for example, by initiating a corporate restructuring)
Non-disclosure of concert parties when disclosure thresholds have been exceeded	<ul style="list-style-type: none"> • Managers should document which other parties (for example, other managers) are concert parties supporting the same strategy • Relevant disclosures should take place if disclosure thresholds are exceeded, accounting for collective share ownership of all parties involved
Prevention of market manipulation	<ul style="list-style-type: none"> • Public relations policies regarding public statements of intent to ensure that no false or misleading impressions are given to the market

6.1.4. Best practice standards and guidance – Disclosure

- Hedge fund manager should disclose to investors in the fund's offering documents whether the manager has a policy to prevent market abuse (no disclosure of the actual policy is required).

Further guidance on market abuse topics applicable to a range of firms can be found in FSA Market Watch publications⁴¹. **In connection with the above, the HFWG believes that the market place would benefit from more guidance on the general concept of “concert parties”, for example when (a) two or more parties will be considered to be acting jointly and (b) a party will be considered to have an interest in shares held by another party.** The HFWG members recognise the complexity of the issues in this area and would welcome further guidance from regulators, as well as being ready to participate in necessary debate.

Side box: Examples of inside information

- Knowledge of another hedge fund manager's intention to engage in activist behaviour (which is not publicly disclosed).
- Inside information obtained by a manager while serving on a creditor committee in a bankruptcy work-out situation.
- Information on upcoming securities offerings, which have not yet been publicly announced by the issuer.

6.1.5. Consultation questions

- *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”?*

6.2. Shareholder conduct: Proxy voting of stock owned

6.2.1. Background

Assets under management by the hedge fund industry have significantly increased over recent years and hedge funds have become powerful participants in equity markets. As part of their duties to their clients, hedge fund managers should participate in corporate decisions that affect the performance of investments.

The HFWG has identified the following issue:

- Do managers fulfil their duty to vote proxies where it is in the best interest of investors?

⁴¹ Market Watch No. 15, 17 (Anti market abuse systems and controls); No. 20 (shareholder activism); No. 21 (controls over inside information relating to takeovers), http://www.fsa.gov.uk/pages/About/What/financial_crime/market_abuse/library/newsletters/index.shtml

6.2.2. FSA Principles

- (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.

6.2.3. Best practice standards and guidance – Governance

- Hedge fund managers should have a proxy voting policy which allows their investors to evaluate the general approach the manager takes towards proxy voting and to determine whether this approach is consistent with their own objectives. A best practice approach in a proxy voting policy document would include the following elements:
 - Guidelines as to the process to be followed to decide how to exercise voting rights, including responsibility to vote and mechanisms to resolve potential conflicts of interest
 - A mechanism to review proposals that are not considered to be in the best overall interests of a company in which the hedge fund is invested
 - Process for deciding when and how to communicate with a company’s management or board of directors and other shareholders
 - Process for determining whether to join the efforts of other concerned investors, with due regard to compliance procedures (see guidance on concert parties in Section 6.1 (*Prevention of market abuse*)) to prevent market abuse
- **The HFWG acknowledges that not all firms will be in a position to vote all proxies (for example, “black box” traders⁴²) and might, for cost benefit considerations, adopt a systematic approach, for example never voting except in exceptional circumstances, rather than evaluating each proxy situation. If a firm decides to take a systematic approach or decides otherwise to deviate from best practice, this process should be disclosed and explained to investors.**

6.2.4. Best practice standards and guidance – Disclosure

- **The proxy voting policy document should be made available to investors and companies (in which funds managed by the fund manager are invested) upon request. The policy should also be set out in the fund’s annual accounts. The hedge fund manager should also document cases where the voting policy has not been followed and report to the fund governing body.**

6.2.5. Consultation question

- *To what extent would stakeholders value this new requirement?*

⁴² Black box trader: Computerised, automated trading system, which generates buy and sell signals based on proprietary algorithms, often executing a larger number of trades.

6.3. Shareholder conduct: Disclosure of derivative positions

6.3.1. Background

Derivatives such as Contracts for Difference (CFDs) allow investors to obtain economic exposure to stocks. There are many reasons for seeking exposure via derivatives rather than buying the stock directly, including market access, stamp tax and funding/leverage⁴³. The HFWG is conscious that these derivatives do not normally fall under the same disclosure requirements (in the UK, for example, under the FSA's Disclosure and Transparency Rules⁴⁴) as owning stock.⁴⁵

The HFWG has identified the following issue on 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, thereby giving a misleading impression to the market?

6.3.2. FSA Principles

(1) Integrity – a firm must conduct its business with integrity.

(11) Relations with regulators – a firm must deal with its regulators in an open and co-operative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

6.3.3. Best practice standards and guidance

The HFWG acknowledges that companies have a right to know who owns them or who has an ability to easily obtain significant voting power. Indeed, members of the HFWG would welcome higher levels of disclosure.

However, the voluntary adoption of enhanced disclosure requirements by hedge fund managers (or any other particular sector of the market) would cause distortions in the market place because they would not apply to all market participants but merely to hedge funds.

Therefore, the HFWG recommends that regulators take action to introduce a regime (similar to that of the Takeover Panel in the United Kingdom applicable during takeover offer periods) requiring notification of “economic” interests in shares held via instruments such as CFDs.

The HFWG members are willing to contribute to consultations with regulators to work out a solution that enhances the current disclosure regime.

6.3.4. Consultation question

- *Would consultees be prepared to enter debate about improved disclosure (eg of contracts for difference)?*

43 When buying stock, the investor will have to pay the market value of the holding. In the case of a derivative, the investor might only be exposed to the changes in value of the underlying stock, but with no need to fund the position at the outset, save for the posting of margin.

44 Disclosure and Transparency Rules, eg requiring disclosure of share ownership if 3% threshold is exceeded and for each percentage point thereafter (UK companies) or 5% (non-UK companies).

45 NB: There is a disclosure obligation if under the terms of the derivative the fund can require physical delivery of the underlying securities.

6.4. Shareholder conduct: Voting of borrowed stock

6.4.1. Background

Securities lending arises when a holder of securities agrees to provide them to a borrower for a limited period of time secured against pre-agreed collateral or cash. At the end of the lending period, the borrower returns the securities, or an identical equivalent, to the holder. The holder receives a fee from the borrower for the use of the borrowed securities. Since ownership passes to the “borrower”, stock “lenders” lose the right to vote their stock although they retain the economic interest, while the borrower obtains the right to vote.

This has given rise to concern that some market participants could borrow stock to vote, while not being economically exposed. As a result, the voting rights attaching to the holding would not necessarily be exercised in the best interest of the lender who has the economic exposure. The HFWG is concerned that this use of borrowed stock undermines investor confidence in the results of shareholder votes. Since this issue is not specific to hedge funds but is of wider application, the HFWG would welcome wider consultation with regulators and market participants to develop a regime that is applicable to all parties and ties votes to underlying economic exposure.

The HFWG has identified the following issue:

- Is it appropriate for hedge funds to borrow stock to vote while not economically exposed?

6.4.2. Best practice standards and guidance

- **Hedge funds following best practice will not engage in practices such as voting on borrowed stock while not being economically exposed.**
 - The HFWG would be happy to engage in wider consultation on this issue with regulators and other market participants
 - The HFWG would welcome a regime where the voting party had an economic interest corresponding to the votes it was casting

Side box: Benefits of stock lending

The use of stock lending has grown significantly over the past few years, driven by investors seeking to go short by selling stock they do not own, borrowing for failed trades (caused by administrative problems) and borrowing for margin requirements. From a lender perspective, it allows a fee to be earned thus enhancing investment returns. Ultimately, stock lending significantly contributes to market liquidity and reduces the risk of failed trades.

6.4.3. Consultation question

- *Would other consultees value a wider debate aiming at voting being restricted to those holding economic interest?*

Appendix A. 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' interest	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 B. Leverage

Leverage is the sensitivity of the portfolio to changes in risk factors such as market prices. There are several drawbacks that complicate the use or comparison of leverage “numbers”:

- There is no single agreed definition of leverage. Definitions cover a spectrum ranging from traditional balance sheet type leverage measures to risk based measures (the latter incorporating underlying risk factors such as Value-at-Risk) and dynamic leverage measures (see table below)
- Classic “financial statement based” leverage is not an independent source of risk, so additional information on the underlying risk factors is required
- Leverage “numbers” have to be considered carefully and may not always contain meaningful information. In some instances, a risk reducing transaction can increase some leverage measures while decreasing others.

It may therefore be difficult accurately to compare leverage between different funds. However, in managing a fund and communicating with investors, hedge fund managers should come up with a leverage definition which is meaningful in their context and track changes in leverage over time.

Classic *financial statement based leverage* definitions are not stand alone risk measures and fail to incorporate off-balance sheet positions (for example, derivatives), which could increase or decrease leverage. *Risk based leverage measures* try to overcome the shortcomings of classic measures by relating a risk measure (for example, market risk) to the fund’s capacity to absorb this risk (for example, the fund’s equity). More sophisticated *dynamic measures of leverage* incorporate a hedge fund manager’s ability to adjust its risk position during periods of market stress.

Examples of leverage measures

Type of measure	Definition	Observations
Financial statement/asset based (classic)	<ul style="list-style-type: none"> • Gross assets/equity • Gross debt/equity 	<ul style="list-style-type: none"> • Does not incorporate on-balance sheet hedges and off-balance sheet instruments
	<ul style="list-style-type: none"> • Net assets/equity • Net debt/equity 	<ul style="list-style-type: none"> • Does incorporate on-balance sheet hedges (therefore “net”), but does not include off-balance sheet instruments
Risk based	<ul style="list-style-type: none"> • Portfolio volatility/equity • VAR/equity • Stress loss/equity • Other loss measure/equity 	<ul style="list-style-type: none"> • Usually incorporates all (on- and off-balance sheet) hedge positions • But does not account for mitigating measures by manager in times of distress
Dynamic	<ul style="list-style-type: none"> • Loss (assuming mitigating action by manager)/equity 	<ul style="list-style-type: none"> • Allows manager action, such as “delevering” by reducing debt or “derisking” by hedging/exiting positions

Appendix C. Examples of functions often covered by service level agreements

Valuation and administration	
Net Asset Value and Share Price calculation	<ul style="list-style-type: none"> • Timing of NAV release (including estimated NAVs) • Process for NAV sign-off (roles and responsibilities) • NAV and other reporting requirements • Valuation policy (particular reference to hard-to-value instruments and use of estimates) • Process for ensuring completeness and existence of positions (reconciliations of cash and positions, trade confirmations etc) • Sign off and notification of share price to external parties • Errors policy in place
Shareholder Services	<ul style="list-style-type: none"> • Subscriptions/Redemptions & Transfers <ul style="list-style-type: none"> – Accurate receipt of application/redemption instructions from investors in line with fund prospectus – Timely provision of subscription note/contract notes to investors – Reconciliation of cash transferred to/from the subscription/redemption account to/from the custody/trading accounts on a monthly basis – Timely payment of redemption monies in line with local regulatory requirements and fund prospectus • End Investor Servicing <ul style="list-style-type: none"> – Timely provision of investor statements containing holdings, latest NAV per share and market value of holding – Timely responses to investor/manager queries – Timely and accurate notification and process of corporate action – Money laundering – Ensure there are policies and procedures that meet or exceed requirements imposed by the anti-money laundering (AML) regulations set by their local regulator – Application of best practice AML/know-your-customer (KYC) requirements in line with jurisdictional and prospectus requirements – Monitoring and reporting of suspicious activity • Regulatory Filings <ul style="list-style-type: none"> – Completion and submission of statutory/listing filings as required (in conjunction with Corporate Secretary) • Monitoring • Employment retirement income security act (ERISA) and other investor tax requirements.

Prime brokerage	
Transaction Processing	<ul style="list-style-type: none"> • Ability to handle Security and FX trades • Ability to handle corporate actions • Definitions of accounting policies for interest and income accruals • Charges and expenses including performance fees • Subscriptions, redemptions and transfers – trade orders, order confirmation, trade confirmation • Cash management – cash balance review, cash movements • Reconciliations – when performed and detail of reconciliation • Monthly custodian reporting – reporting contents, for example, settled positions, latest prices, market value
Compliance	<ul style="list-style-type: none"> • Pricing control • Error and breach reporting • Compliance monitoring
Auditing	
Accounting and Financial	<ul style="list-style-type: none"> • Accounting standards used • Filing of accounts
Other	
Corporate Secretarial	<ul style="list-style-type: none"> • Maintenance of all statutory books and records • Provision of registered office facilities • Organisation of opening of subscription, holding, redemption, brokerage accounts as well as trading and any other bank accounts as required • Annual Reports and organisation of annual meetings and emergency general meetings • Arrangement execution of legal documents by fund directors • Submission of required information to relevant regulatory body

Appendix D. Market abuse

For behaviour to constitute market abuse under the Financial Services and Markets Act 2000 (FSMA), it must (a) occur in relation to a qualifying investment admitted or to be admitted to trading on a prescribed market; (b) fall within one of the seven types of behaviour set out below; and (c) not fall within a safe harbour created by the Code of Market Conduct.

Seven types of market abuse offences ⁴⁶

Offence	Explanation
1. Insider dealing	Activity based on information from an inside source (for example, a company director) (<i>MAD Offence</i>)
2. Improper disclosure	Disclosure by an insider to another person otherwise than in proper course of the exercise of his employment, profession or duties (<i>MAD Offence</i>)
3. Misuse of information	Dealing on the basis of information that is generally not available to those using the market (<i>retained UK law offence</i>)
4. Manipulating transactions	Dealing to give false or misleading impressions as to supply, demand or price or trading at abnormal levels (<i>MAD Offence</i>)
5. Manipulating devices	Executing, pumping or dumping, trashing or cashing or similar deceptions (<i>MAD Offence</i>)
6. Dissemination	Engaging in dissemination of information to give false or misleading impressions (<i>MAD Offence</i>)
7. Misleading behaviour and distortion	Engaging in behaviour that gives false or misleading impressions or is likely to distort the market (<i>retained UK law offence</i>)

The five market abuse offences introduced by MAD relate to investments traded on all markets established under the rules of a UK recognised investment exchange (including the Official List and AIM), OFEX and all EEA regulated markets. The two retained UK law offences relate to investments traded on markets established under the rules of a UK recognised investment exchange (including the Official List and AIM) and OFEX, but not to investments traded on any other EEA regulated market.

If the behaviour in question occurs in relation to securities traded or to be traded on a market established under the rules of a UK recognised investment exchange, it can still constitute an offence under FSMA wherever the person committing the act is located. This is the case for all seven types of market abuse offences.

If, however, for the MAD offences the behaviour in question occurs in relation to securities traded or to be traded only on an EEA regulated market (outside the UK), then the person committing the act must be within the UK at the time of commission for there to be an offence under FSMA (although, of course, such a person will also be subject to applicable law in the jurisdiction in which he is located and potentially also in the jurisdiction in which the effects are experienced).

⁴⁶ FSA handbook: <http://fsahandbook.info/FSA/html/handbook/MAR/1>

Appendix E. 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 – Co-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 – Co-Chair David Burnett, TT International Michael Cohen, Och Ziff	Simon James, Cheyne Capital Cathy O'Reilly, TCI Fund

Appendix F. 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?
Sectoral 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?
Disclosure to investors and counterparties 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?

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