HFWG
Hedge Fund Working Group

January 2008

Hedge Fund Standards: Final Report

Contents

How to read this report

The Hedge Fund Working Group (**"HFWG"**) Final Report (the "**Report**") is a package of materials which consists of:

- This Report, which is available in hard copy and on the website, containing background to the exercise, a summary of the consultation feedback, the revised best practice standards for hedge funds (the "**Standards**"), and the way forward (such as signing up to the Standards)
- Also on the website (http://www.hfsb.org) are:
  - *Accompanying the report:* The consultation questions, consultation feedback which consultees have agreed to publish, and a summary of the consultation feedback. All of these amplify the Report.
  - *General information*: Contact details, information on the Hedge Fund Standards Board and FAQs, the Standards and a signatory pack of documents for managers wishing to sign up with the Hedge Fund Standards Board (**"HFSB"**) to register their conformity (or intention to conform) with the Standards.

For general readers, the Report should suffice. For professional readers and others requiring further information, the additional materials on the website should be of assistance. Please visit http://www.hfsb.org.

1. Foreword

When the Hedge Fund Working Group began its deliberations in June 2007 we knew that this, our Final Report, would be a beginning rather than an end. From the outset, the industry has led the exercise and I believe it is of real significance that hedge funds themselves have created a set of high quality best practice standards. The industry has broken new ground and now the baton passes to the Hedge Fund Standards Board and all other participants in the hedge fund industry to continue the work.

The Standards set out in this Report flow from the Consultation Paper published in October 2007 and the responses to it. I would like to thank everyone who took so much time and trouble in answering our invitation to give their opinions on the paper. The quality of the consultation responses was impressive, and the work and the thought which went into the many individual submissions no less so. Importantly, the comments we received extended beyond the content of the Standards to how the Standards become legitimised by use on the one hand and being kept up to date on the other.

This demonstrates the seriousness with which participants view the long-term implications of the exercise for fund management as a whole, given the prominence and increasingly mainstream nature of the hedge fund business. It also demonstrates that firms will see the level of integrity and behaviour embodied in the Standards as being of value for their own business, and that the Standards will be attractive to investors, consultants and regulators, who in turn will be a powerful influence on hedge fund managers.

The questions now are: What is the way forward? How does the wider picture look? There are several answers which strike me as being especially germane.

First, this is an exercise in market discipline, based on disclosure. Although for UK managers the Standards are designed to fit within an existing well developed regulatory framework, the industry has devised the process on the premise that its users – and predominantly its investors – will give the Standards and conformity with them considerable weight in their business decisions. A manager shunned for lack of conforming risks suffering the consequences. Moreover, market discipline should ensure that the process is dynamic: it is intended and expected that the Standards will evolve as circumstances change.

Second, our work has highlighted a number of issues which are of importance far beyond the hedge fund industry. Tackling these issues from the point of view of hedge fund professionals should shed light on debates which are vitally needed in a broader context than the hedge fund industry alone. The question of valuation of hard-to-value assets is a particular example. Another is the management of liquidity risk. The events of recent months have shown how important these questions are. Confidence in financial stability is crucial, but it has been severely shaken. Finding ways of handling questions such as valuation and risk in a more transparent and better informed fashion will be central to re-establishing confidence. Yet the financial community is still some distance from finding satisfactory answers. I hope that the Hedge Fund Working Group's contribution to those debates will illuminate discussion across the financial industry – including the major banks, investment banks, regulators, accountants and lawyers. I am sure that the hedge fund industry is ready to help take the discussion forward.

The third point is the applicability of the Standards. As the industry matures the dividing line between what is hedge fund management and what is not becomes increasingly blurred. Although the Standards are designed for today's hedge fund managers, some – perhaps most – of the Standards will probably be relevant in other areas. If they are, it will be for the industry participants and their users in those other areas to decide on how to adapt them for their own purposes.

Finally, there is the global dimension. Our initiative has deliberately been anchored in the UK, referring as it does to the FSA Principles with which FSA regulated managers are bound to comply. These Principles act as powerful behavioural determinants. But if globally active investors feel that the Standards have value– and if they do not the exercise will have failed – there is little reason for the Standards to be of lesser relevance to managers located in other countries.

All this leaves the Hedge Fund Standards Board ("HSFB") and its Board of Trustees with some critical tasks. In the immediate future, it needs to smooth the path for many firms beyond the 14 original members of the Hedge Fund Working Group to sign up to the Standards. It also needs to monitor the extent to which conformity with the Standards takes place in practice. Without such monitoring, the process will wither and the risks of regulatory or other official intervention will increase.

One measure of success will be the extent to which hedge fund managers in other countries sign up to the Standards. So another early task for the Board of Trustees will be to evaluate the differences between the Standards set out in this Report and those expected soon from the US President's Working Group on Hedge Fund Managers. Our two groups have shared information and cooperated from the outset. The US and the UK jurisdictions together are home to about 85% of hedge fund assets under management globally.

There will be healthy pressure for a cooperative globalisation of best practice standards through convergence where it is possible and desirable in terms of industry practice and is not constrained by regulation, law or indeed legitimate difference of business approach. The main thing is that differences will be transparent and lend themselves to constructive debate to find the best way forward for this globally active industry and its users. The potential benefits from a global convergence of standards are huge.

In the longer term, since much will depend on those able to exert discipline playing their parts, the Board of Trustees will also need to keep its finger on the pulse of the users of the industry as well as the hedge fund managers. At the same time, it will be important to maintain constructive relations with the public authorities. To my mind, it is most encouraging that the regulator in the UK and other regulators elsewhere have welcomed the exercise. Although the Standards have no formal regulatory status, knowing that the public authorities are well disposed towards the process should help to give them additional authority. What is clear to me is that unless the Standards are kept up to date and relevant, as a result of contact with the stakeholders, the process will wither and the risks of regulatory or other official intervention will increase.

Any industry-led initiative which accepts responsibility for its own future is part aspiration. It shows a willingness to raise the bar and to strive for that higher level of behaviour. Inevitably that involves risks and uncertainties, while at the same time seeking to improve confidence in, and respect for, the industry. It is to the credit of this industry and its participants that they have been prepared to embrace the challenge. I have little doubt that the Hedge Fund Working Group initiative, which the industry itself has created, equips the industry with a robust framework to help it face the future. This is surely important at a time of tension in financial markets such as we are experiencing today.

The experience of issuing our Consultation Paper, listening to the industry, and producing this Report has been stimulating for all us. Thanks are due to many. Pride of place, of course, goes to the practitioners, who have done the work, and in particular Marshall Wace for providing infrastructure support and office space. But many others deserve mention. On behalf of the Hedge Fund Working Group, I would like to give special thanks to those who have supported our endeavours, specifically Brad Ziff and Thomas Deinet of Oliver Wyman; Karen Williams; Herbert Smith, particularly Nigel Farr and Tim West; Ratan Engineer of Ernst & Young; Peter Wilson-Smith and John Eisenhammer of Quiller Consultants and Michael Prest. We would also like to thank those who took the trouble to respond to the Consultation Paper and advise us: lawyers (particularly Simmons & Simmons and Dechert), accountants and many other professionals with an interest in the sector. The contribution of the Alternative Investment Management Association ("AIMA") also deserves our thanks.

Sir Andrew Large
Chairman of the Hedge Fund Working Group
January 2008

2. Executive summary

1. This Final Report concludes the work of the Hedge Fund Working Group ("the HFWG"), which started in the middle of last year. It follows our Consultation Paper, published in October 2007, and presents the outcome of the consultation along with the final best practice standards for hedge fund managers as amended by the consultation. Its contents are new in three respects. First, the Standards, which are the core of our recommendations, have been strengthened, updated, revised and clarified. Second, we have elaborated on the process whereby the Standards will be maintained and developed as circumstances change. And third, it sets out how hedge fund managers can sign up to the Standards and the implications for them of doing so.
2. **Background to the Report.** We are publishing the Report because hedge funds are increasingly in the public eye. Chapter 4 deals with some public perceptions of hedge funds. Whether in debt markets, public sector debt management or wider questions of financial stability, their presence is inescapable. Recent difficulties in the credit markets have highlighted the importance of financial stability, even if the role of hedge funds has to date been minor. Hedge fund managers appreciate that public understanding of the industry is limited and recognise that responsibilities accompany its growth and influence.
3. The initiative taken by the 14 members of the HFWG has therefore been an exercise in industry-led market discipline. The HFWG has sought to draw a baseline of best practices to strengthen the confidence of investors, lenders, regulators and other market participants. The foundation for the Standards is the UK Financial Services Authority's 11 Principles of good business conduct (the "**FSA Principles**"). Although the FSA Principles apply directly only to managers who are authorised and regulated by the FSA, they embody tenets of sound business conduct which are behavioural determinants wherever good business is done.
4. However, the Report is a beginning rather than an end. It is now up to the hedge fund industry as whole working with the new Hedge Fund Standards Board ("HFSB") to maintain the Standards and keep them up to date. As to the response required of managers to the Standards, we envisage and describe in this Report a dynamic process based on a comply or explain regime. A manager will "conform" to the Standards if it becomes a signatory to the process run by the HFSB and then, in respect of each of the Standards, either complies with that Standard or explains that it will not so comply and why. The regime thus accommodates managers of all sizes and types around the world and, critically, rests on disclosure. By making managers' stance on the Standards transparent it provides investors and others with an important instrument of due diligence. Pressure from a manager's peer group and investors is likely to be a strong incentive to become a signatory.
5. **The consultation.** Following the Overall Introduction in Chapter 3, Chapter 4 sets out five areas of concern about hedge funds: disclosure to investors and counterparties, valuation, risk management, fund governance and shareholder conduct (including activism). Governance in general is a theme which runs

through all of them. We also set out 15 specific issues relating to the hedge fund industry which the Standards are intended to address. Chapter 5 explains that the consultation produced broad agreement that the five areas of concern were correctly identified. There was also wide support for the industry-led market discipline regime, although many respondents noted that all market participants had to play their part if the Standards were to be kept up to date and effective. The HFWG received 75 written responses and undertook 26 consultation events involving a total of more than 300 representatives from institutional investors, fund managers, prime brokers, rating agencies, supervisors, lawyers, accountants, industry associations and others.

6. **Consultation feedback and the Standards.** Chapter 6 summarises the feedback and the amendments to the Standards resulting from it. A full set of the revised Standards is contained in Chapter 11. Some examples of the topics addressed are:
   - Smaller managers. Concerns were raised that the Standards might be a burden for smaller managers who make up the great majority of hedge fund management firms. But most managers were comfortable with the proposed regime. The Report reflects the HFWG's position which is that the Standards apply to all managers, although amendments have been made to certain Standards to take account of the challenges smaller managers face.
   - Disclosure. Managers should be transparent about fees, investment risks and dealings with lenders and prime brokers.
   - Valuation. Ideally fund valuation should be performed by an independent and competent outside body. If that is not possible, the Standards have been drafted to ensure that in-house valuation is conducted by a segregated function with full disclosure.
   - Risk management. Additional guidance now recommends that portfolio risk disclosure should be more frequent, for example quarterly. A new Standard requires legal and regulatory risk to be addressed in an operational risk context.
   - Fund governance. The central issue is that governance arrangements should be put in place which are capable of dealing with conflicts between managers and investors. The Standards reflect the important role played by managers in seeking to ensure that appropriate governance arrangements are established at the beginning of a fund's life and that appropriate arrangements are in place. More broadly, the Standards also reflect the role of managers in enabling and encouraging fund governing bodies to achieve the various outcomes required by the Standards where such outcomes are ultimately within the control of fund governing bodies rather than the managers.
   - Shareholder conduct including activism: The Standards require managers (a) not to borrow stock in order to vote , and (b) to have a proxy voting policy which allows investors to evaluate the approach. The proposed Standard relating to the disclosure of positions held via CfDs is, however, currently pending the outcome of the FSA's consultation into this issue.

7. **Becoming a signatory.** Chapter 7 describes how managers can sign up to the Standards. It explains that the HFWG chose a comply or explain regime because a

"comply only" regime would have required the Standards to be more detailed and prescriptive. A comply or explain regime also accommodates a dynamic industry covering a diverse range of types and sizes of manager. In addition, the chapter looks at the regulatory status of the Standards.

8. **The Hedge Fund Standards Board.** Chapter 8 looks at the HFSB. HFSB's members – the Trustees – will be custodians of the Standards, charged with keeping them up to date and "fit for purpose". Their mandate also includes maintaining links with stakeholders, such as the industry and supervisors. However, HFSB will not be a trade association. That role belongs to the Alternative Investment Management Association ("**AIMA**"). The interim Trustees are the 14 members of the HFWG, along with Christopher Fawcett, chairman of the Alternative Investment Management Association ("AIMA"). The interim chairman is Sir Andrew Large, chairman of the HFWG. The interim Trustees will appoint the Trustees over the next few months and a permanent chairman is being sought. It is expected that a majority of Trustees will have roots in the industry, but all Trustees will be selected in part for their independence of mind.
9. **The global dimension.** Chapter 9 is concerned with the Standards in a global context. Part of the Trustees' mandate is to consider the scope for a global convergence of standards over time, with particular reference to the findings of the US President's Working Party on hedge funds. The nature of the comply or explain regime means that managers in other jurisdictions can, if they choose to sign-up to the Standards, comply with the Standards as far as their legal and regulatory circumstances might permit and explain when they cannot comply. Financial stability is a critical global concern and HFSB will seek to continue to emphasise such issues as valuation, liquidity risk management and stress testing and scenario planning which bear on financial stability.
10. **Relationship with other bodies.** Chapter 10 deals with HFSB's relationship with other organisations, notably AIMA. It also deals with information about the sector and individual firms. AIMA endorses the HFWG's approach and HFWG recognises AIMA's efforts to enhance industry practices. AIMA and HFSB will work to mesh the Standards and AIMA materials such as industry guidance. The HFWG and AIMA have set up a working party to make more information about the hedge fund industry publicly available. A table provides an overview of the vast range of materials about the industry produced by AIMA and others.

3. Overall introduction

3.1. The nature of this Report

This Report is the result of the consultation which began with the publication of HFWG's Consultation Paper in October 2007. Its contents are new in three important respects: First, the Standards, which are the core of our recommendations, have been strengthened, updated, revised and clarified in the light of comments from respondents during the consultation. Second, we have elaborated on the process whereby the Standards can be maintained and developed as circumstances change. And third, it sets out how hedge fund managers can sign up to the Standards.

3.2. Why are we publishing this report?

Hedge funds have become a prominent feature of the financial system and the global economy. Whether in equity markets, public sector debt management or wider questions of financial stability, their presence is inescapable. As their size and diversity have grown, it is natural that interest in them has grown as well.

Leading hedge fund managers recognise that their own investors and the public are increasingly interested in their activities and that with their growth in importance and influence come responsibilities. They are also aware that understanding of the sector is not as great as it could be and recognise that there are concerns about practices in the sector which need to be addressed. Articulating these best practice standards, to which they intend to conform, is a response to these issues.

This Report, therefore, makes recommendations for improvements and, in so doing, aims to increase understanding of hedge funds.

3.3. The consultation and the Standards

Although the Standards have been clarified and in some important areas, such as valuation, strengthened as a result of the consultation, the basic issues and structure identified in the Consultation Paper remain the same. Respondents agreed that governance and disclosure to investors and lender counterparties, valuation issues, prudential and risk framework issues, and shareholder conduct (including activism) are areas of central importance. They also accepted the critical importance of governance in general and disclosure in particular. Governance and disclosure are core themes running throughout the Report.

3.4. One stage in a dynamic process

The fresh emphasis on the Standards being part of a process is fundamental. Despite being the HFWG’s final report in name and fact, the publication of this Report is a first step along a road. The journey started with an ad hoc group of 14 leading hedge funds taking the initiative to establish a set of best practice standards for an industry which, however successful, was perceived by many to be opaque and arcane. The industry was therefore concerned to draw a baseline of practices to strengthen the confidence of investors, lenders and regulators. It has led to this Report, the Standards within it and the process to keep them up to date. Investors and – where appropriate – regulators, working with the Trustees of the independent Hedge Fund Standards Board, a majority of whom will have their roots in the hedge fund sector, will now share responsibility with the industry for continuing the journey. The Alternative Investment Management Association is being asked to play a major role in developing further guidelines and guidance on the implementation of these Standards where industry participants require it.

3.5. An industry-led exercise in market discipline

After years of rapid growth, a maturing hedge fund industry has recognised the responsibilities attendant on its size and influence. The process has been industry led and principles based. This has helped to bring together in one place, through a single set of linked standards, the disparate existing elements of industry guidance. The foundation for our work has been the FSA Principles (listed at Appendix B) to which all FSA authorised and regulated fund managers are required to adhere. Although the Standards are of direct relevance only to such managers, however, the FSA Principles embody tenets of sound business practice which are relevant behavioural determinants wherever good business is conducted. It is also worth noting in this context that the FSA Principles are consistent with the requirements imposed by MiFID[1] to act fairly, honestly and professionally in accordance with client' best interests (19(1) MiFID level 1) and to provide clients with information that is fair, clear and not misleading (19(2) MiFID level 1). We expect that both managers and investors should find them to be of value irrespective of the country of incorporation or regulatory status of the manager.

3.6. Achieving conformity with the Standards

Conformity with the Standards will be through a comply or explain regime, the foundation of which is disclosure. A manager who becomes a "signatory" to the Standards "conforms" to the Standards if in respect of each Standard, it either complies with that Standard or explains that it will not so comply, and why. It should be noted that there is no suggestion that "explaining" is an inferior option to complying. Vitally, this is an exercise in market discipline. Far from depending on prescriptive regulation, market forces – especially pressure from investors – will be the main incentive for firms to conform to the Standards. Indeed, it will be clear to the reader of this Report that most of the Standards are designed with the investor in mind. The importance of investors in relation to the best practices is that compliance with voluntary standards requires market processes to gain momentum. On the one hand, there is likely to be peer group pressure to conform to the Standards. On the other hand, however, an equally strong determinant of conformity will be the demands of the investors.

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[1] Markets in Financial Instruments Directive (Directive 2004/39/EC).

The HFWG encourages all types of investors in hedge funds (for example, funds of funds, institutional investors, high net worth individuals, and so on) to use the Standards in their due diligence of hedge fund managers. This should help to ensure a consistency in the way the Standards are adopted and will increase acceptance throughout the industry. The comply or explain regime is dealt with at greater length in Chapter 7 *(Becoming a signatory)*.

3.7. Regulatory status

As a result of our consultation, this Report sets out best practice standards which the HFWG believes reflect best practice in the hedge fund industry today. The Standards have been constructed in the light of the FSA Principles applicable to FSA authorised and regulated fund managers and therefore constitute guidance from the HFWG as to how it believes the FSA Principles should be interpreted and applied where hedge funds are concerned. It is important to note, however, that whilst the HFWG has been in contact with the FSA during the development of this 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 function.

Under the UK regulatory regime, there are two types of industry guidance: "confirmed" and "unconfirmed". Confirmed industry guidance has "sturdy breakwater" status, which means that the FSA will not take action against any regulated firm that has adhered to such industry guidance. The Standards, however, represent “unconfirmed” rather than “confirmed” industry guidance. The absence of "sturdy breakwater" status for the Standards, however, does not mean that we believe they are in any way sub-standard for their purpose or that they will not inform any proper interpretation of what the FSA Principles require. This is explored further in Appendix D.

4. Issues affecting hedge funds

4.1. Hedge funds and general perceptions of them

Certain questions about hedge funds recur frequently and are representative of the views held by some sections of the public. While the aim of this Report is to address a number of specific issues which are directly relevant to the hedge fund sector, some observations on these more general questions may be pertinent. A diagrammatic representation of a typical hedge fund structure is at Appendix G *(Illustration of typical hedge fund structure)*. In addition, Appendix E *(Leverage)* looks at the central question of the use of gearing by hedge funds. Specimen questions, together with our responses, are set out below.

"Isn't there a lack of clarity about what hedge funds are or do?"
Much has been written on this subject[2], but there is no legal or regulatory definition of a hedge fund in the UK. One useful way to understand hedge funds is to compare them with a classic (long-only) fund, as in the table below. In addition, our website carries a background paper, "The Hedge Fund sector: History and present context", which examines the historical development of the hedge fund sector in greater depth.

Defining features of hedge funds[3]

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

"Isn't there a lack of transparency and data about hedge funds?"
The sector has grown extremely rapidly. There is accordingly no standardised data, and little consolidated publicly available data, about the industry. The criticism is not without

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

[3] Oliver Wyman: Perspectives on Asset Management – Hedge Funds, growth sector or maturing industry? (06/2005).

foundation, and the issue has been a source of frustration to many: the report accordingly addresses this question in Chapter 10.2 (Sector information).

"Are they regulated enough?"
Despite comments suggesting otherwise, broadly all UK-based hedge fund managers are regulated in the UK. They are therefore required to comply with the FSA Principles[4] and the rules and guidance in the FSA's Handbook. Generally speaking, these FSA Principles, rules and guidance apply to all regulated activities undertaken by FSA regulated hedge fund managers. Furthermore, to the extent that regulated hedge fund managers delegate any regulated activities to third parties, they remain responsible to their customers for compliance with these principles, rules and guidance with respect to the performance of such activities. The UK is distinct from many other jurisdictions, including the US where regulation of the sector is less embracing and lacks such a set of statutory principles.

"Don't they take too much risk?"
Compared to traditional fund management strategies, some hedge fund strategies employ higher levels of risk and some have failed. Investors therefore need to be able to make well-informed judgments about the strategies undertaken and the degree of risk involved. At the same time, many hedge fund strategies are arguably less risky and less volatile than "long-only" investment in familiar instruments such as debt securities and equities.

"Don't they have too much power and too little accountability?"
Hedge funds and their managers are considered by some to be too powerful or insufficiently accountable. Increasingly, however, hedge fund managers acknowledge that power and accept the responsibilities commensurate with it. In addition, hedge fund managers are required to comply with, amongst other things, the FSA Principles. Our Report outlines what the HFWG considers to be the best practice approach to complying with the FSA Principles.

"Aren't hedge funds responsible for too much corporate activism?"
Hedge funds are seen by some as short-term activists in their relations with companies in which they have an interest. Naturally, there are activist hedge funds, just as there are entrepreneurs, investment banks, and traditional asset managers who are active investors. However, with approximately $50 billion of assets under management, activist hedge funds only constitute 3.3% of total global hedge fund assets, a small portion of the overall sector.[5/6] This compares with a private equity buyout volume (public-to-private) of $120

[4] See Appendix B (*FSA Principles*).

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

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

billion (in the US), £5.8 billion (in UK) and €25.7 billion (in continental Europe) in 2006 alone.[7]

"What's the difference between private equity and hedge funds?"
The two are very different. The British Private Equity and Venture Capital Association ("**BVCA**") defines private equity as "medium- to long-term finance provided in return for an equity stake in potentially high growth unquoted companies".[8] This usually involves a combination of provision of capital and expertise from private equity executives. Hedge funds involve a form of direct asset management of portfolios of a wide variety of mainly financial assets. They do not seek to buy out firms that are publicly quoted, nor take responsibility for managing them. That said, there are areas of overlap and indeed a few hedge fund strategies approach those of private equity.

4.2. Specific hedge fund issues

We have identified 15 key issues relating to hedge fund practice and address them in this Report. These issues can be grouped into five themes: Disclosure, Valuation, Risk, Fund Governance and Shareholder Conduct.

Overview of issues
The issues we identified and for which the Standards have been created are set out in the table below.

Area of concern		Issue
Disclosure	Investment policy	▪ Do hedge fund managers describe their investment policies and associated risks with the investments in sufficient detail?
	Commercial policy	▪ Do hedge fund managers provide adequate disclosure to investors about the commercial terms applicable to an investment in their fund?
	Performance measurement	▪ Do hedge fund managers sufficiently disclose the robustness of their performance calculation?
	Disclosure to lenders	▪ Do hedge fund managers provide lenders with sufficient information to assess risk adequately?
Valuation	Separation of duties	▪ Do hedge fund managers adequately mitigate potential conflicts of interest and provide investor with sufficient information about the valuation process?

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

[8] Further details can be found at the BVCA website: A guide to Private Equity, http://www.bvca.co.uk/publications/guide/intro.html and Guidelines for Disclosure and Transparency in Private Equity, November 2007, http://www.walkerworkinggroup.com

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

4.3. Applicability of the Standards to particular types of management activity

The Standards have been designed so as to apply to fund managers solely in respect of their management activities in relation to hedge funds for which they act as investment manager. They do not apply to other activities including, by way of example, management activities in relation to segregated accounts or fund of hedge funds, although certain of the Standards might, with or without adaptation, be appropriate for hedge fund mangers to utilise in carrying out those other activities. We recognise, however, that it is of course possible that certain of these Standards might also be capable of application to other areas of such managers' activities and that consequently a manager may well wish to specify, for the avoidance of doubt, any areas of its business to which the Standards are not applicable. Given that the Standards are intended to apply only in respect of a manager's hedge fund management activities, we would have no objection to this approach.

Certain of the Standards may also be capable of application to other areas of the asset management industry. If participants in those areas find any of the Standards helpful and wish to adopt or adapt them for their circumstances then they are of course free to do so and we would welcome that.

4.4. Applicability to smaller managers

The HFWG encourages broad adoption of the Standards by managers involved in hedge fund management in the UK irrespective of their size and the stage of development of their firms. Although fund managers who founded the HFWG may be considered more "established", each having more than US$4 billion under management, the Standards are equally applicable to smaller as well as larger firms.

During the consultation, some felt that established managers may find it easier at the outset to comply or take steps to achieve compliance or otherwise explain their approach than a smaller manager or start-up. A smaller manager could, for example, face resource constraints in producing more detailed documentation to explain its approach to investors on broader comply or explain issues.

The HFWG has been aware of this concern and has added acknowledgements in some Standards which take account of specific challenges facing smaller managers. Moreover an explanation from a manager as to why it is unable to comply with a particular Standard by reference to such considerations may be considered entirely appropriate in the circumstances.

5. The consultation

Our Consultation Paper published in October 2007 launched a wide-ranging and valuable consultation on these issues. During the consultation, a variety of consultees, including managers, investors, suppliers, and public authorities, indicated their support for the Standards. We also received many constructive comments which have helped us to improve and clarify the Standards. Equally, we received valuable comments on, and questions about, the process for safeguarding and developing the Standards. The list of consultation questions is at Appendix I (*Consultation questions*).

5.1. Support for the Standards

Many of those commenting on the Consultation Paper accepted the premise that the hedge fund industry is maturing and that to enhance confidence in the industry in the longer term it had to accept the responsibilities consistent with its standing.

Building on that premise, respondents accepted the value of an industry-led market discipline regime. Respondents recognised that the process of safeguarding and developing the Standards could bring managers, clients and suppliers together. Under the leadership of the Board of Trustees of HFSB, with support from AIMA, the industry would be the major influence on how the Standards evolve.

Respondents also agreed that an industry-led market discipline regime could reduce the possibility of unsatisfactory regulatory intervention or legislation. On the one hand, if the regime is successful, regulators are less likely to introduce external regulation of the industry. On the other hand, should regulators feel the need to step in, the Standards could well be a realistic blueprint for external regulation and reduce the chances of a regulatory regime being imposed which the industry considers unpalatable.

Some managers doubted the need for any initiative by the industry. They took the view that many hedge funds are private businesses which have generated good returns for their investors. The more general view among respondents, however, was that doing nothing is not an option. Failure by the industry to take the initiative now runs the serious risk of leaving the field open to more restrictive external intervention in the future.

But market discipline places considerable responsibility on the industry. Many respondents noted that, for the benefits to be realised, all relevant parties need to have confidence in, and respect for, the process and its mechanisms. The Standards and the mechanisms for constructing them had to continue to be seen as "fit for purpose".

5.2. Keeping the Standards up to date: defining the process

Given the importance respondents attached to the process for ensuring that the Standards remain up to date and command continuing respect, we set out below the main elements of the process designed to achieve this. It requires:

- a set of best practice standards informed by consultation;
- a mechanism for keeping the Standards up to date (see Chapter 8 (*The Hedge Fund Standards Board*));
- a credible Board of Trustees charged with ensuring that the mechanism works (see Chapter 8 (*The Hedge Fund Standards Board*);
- a comply or explain regime which also covers how hedge fund managers sign up with the Board of Trustees and certify themselves to enable third parties to know who is and who is not a signatory to the regime (see Appendix C (*Signatory Pack*));
- market discipline, including the peer group, investors, lenders or public authorities, which will encourage adoption of the regime (see Section 7.4);
- managers and other market participants to have confidence in the process; and
- a growing number of signatories as managers come to appreciate the benefits of being able to declare their conformity. The 14 members of the HFWG are signatories as from 22 January 2008.

5.3. Terminology and definitions

Since this is a new process it is important to be clear on terminology. Here are some of the terms used.

- Board of Trustees. The body formed to act as guardian or custodian of the Standards.
- Signatories. Hedge fund managers who agree to adopt the Standards and to conform to them.
- Comply or explain. Signatories to the Standards must either comply with each of the Standards or explain that they intend not to comply with a particular Standard and why. The explanation process is described in Section 7.1.
- Conform. A hedge fund manager conforms to the Standards if it either complies or explains in respect of each Standard.
- Endorsement. Relates to third parties such as investors, fund governing bodies, suppliers to and users of the industry, rating agencies, consultants and trade associations who accept the merits of the process, and are likely to note whether managers are signatories to, and adopt and conform to, the Standards when dealing with them.

6. Consultation feedback summary and best practice Standards

The HFWG is very grateful to all those who responded to the Consultation Paper. In total, 75 written responses were received. The HFWG also undertook 26 consultation events reaching out to some 300 investors, hedge fund managers and prime brokers. Feedback raised a wide range of valuable points about Disclosure, Valuation, Risk Management, Fund Governance and Shareholder Conduct. Other important issues included the impact of the Standards on smaller hedge fund manages and their ability to meet the Standards, the relationship between fund governing bodies, managers, funds, and investors, trustee arrangements and convergence.

Based on the feedback, some of the Standards have been amended to incorporate issues raised. In a number of cases, feedback was much more detailed than the high level Standards proposed here, and certain issues require wider debate with a broader set of industry participants and could not be settled by this exercise. Indeed, some consultees raised the general point that more detailed industry guidance than the Standards has already been available from bodies such as AIMA for many areas, including in relation to valuation, governance and ethics. The aim of HFWG, however, was to arrive at a set of non-prescriptive standards which could cover the whole hedge fund sector. As a consequence, the Standards have been pitched at a high level. They naturally require guidance to cover the more particular needs of different market sectors and strategies, The HFWG has added some guidance to the Standards but there is no value in duplicating existing high quality material. Instead, references are provided to assist managers in locating such guidance material.

Going forward, the HFWG believes that AIMA is well placed to take the lead on producing further guidance in relation to the Standards were it to become apparent that such guidance would be beneficial. This could involve issuing new or amending existing materials (which could ultimately be referenced in, and meshed in with, the Standards) or may require in some areas further consultation with a broader set of constituents, such as investors.

The website (http://www.hfsb.org) contains a summary of the consultation feedback ("**Consultation Summary**").

The following sections provide a high level overview of some of the key issues identified during the consultation and any resulting alterations to the Standards.

6.1. Smaller manager perspective

The HFWG encourages broad adoption of the Standards by hedge fund managers in the UK and beyond irrespective of their size. Although the hedge fund managers who founded the HFWG are considered more "established", each having more than US$ 4 billion under management, the Standards are applicable to smaller as well as larger firms.

Some consultees felt, however, that established managers may find it easier at the outset to comply or take steps to achieve compliance or otherwise explain their approach than a smaller manager or start-up which may, for example, face resource constraints.

The HFWG has been aware of this concern from the beginning and has solicited consultation feedback on whether the Standards pose particular challenges to smaller managers. It also asked consultees to identify where compliance might be most challenging for smaller managers.

Overall, the consultation feedback and discussions with industry participants indicated that hedge fund managers of all sizes felt comfortable with the proposed disclosure-based comply or explain regime and the flexibility which it affords managers to explain non-compliance where their size has impacted their ability to comply. Managers generally found this preferable to other approaches, including a rules-based prescriptive approach which some advocated. The HFWG did not therefore consider it necessary to create a separate tier of Standards for smaller managers although amendments have been made to certain Standards to cater for particular challenges likely to be faced by smaller managers (for example in relation to the Standard requiring segregation of the valuation and portfolio management roles within a hedge fund manager, the Standard provides that if such segregation is impracticable, a smaller manager may elect instead simply to disclose this fact to investors).

Appendix F (*Areas of concern from a smaller manager perspective*) contains a more detailed overview of some of the areas posing challenges for smaller managers and how they have been addressed.

6.2. Disclosure

6.2.1. Investment policy and risk disclosure

In its consultation paper, the HFWG asked the following consultation questions regarding its proposed approach to investment policy and risk disclosure:

- *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?*

The main issues that were raised during the consultation centered on standardisation and the frequency of disclosure.

Consultees had a wide spectrum of views relating to standardisation of disclosure. Some felt that the disclosures required by the Standards were too prescriptive, codified and bureaucratic, and could potentially impair manager flexibility in managing the fund. Others suggested that disclosure should be further standardised (both upfront disclosure and ongoing reporting) to facilitate analysis and comparison between funds.

The HFWG is acutely sensitive to the complexities investors face in gathering consistent data about funds to carry out comparisons and analyses. However, given the breadth of hedge fund strategies and risk profiles, it is difficult to attempt to prescribe a single comprehensive set of risk measures (and their respective definitions) that would be applicable to all types of hedge fund strategies. The discussion on the spectrum of feasible leverage definitions illustrates the complexities which arise when seeking standardisation (see Appendix E, *Leverage*).

While the HFWG agrees that there is merit in further exploring standardisation of certain elements of disclosure, the time and effort required to bring about a widely accepted convergence of definitions would be beyond the scope of these Standards. Therefore, the HFWG recommends that AIMA considers further exploration with hedge fund managers, investors and other relevant industry bodies on approaches that would foster consistency and standardisation. The Standards have accordingly not been changed as a result of the consultation process.

Some consultees felt that risk- and performance-related disclosures required by the Standards should be provided more frequently than just in the annual report. The HFWG has therefore added further guidance to the Standards in this respect.

Finally, a significant number of detailed disclosure items were brought up during consultation. Many of these points have significant merit but once again it was felt they were better handled by way of subsequent guidance rather than prescriptive best practice. The HFWG hopes that AIMA will consider taking this forward if it feels there is sufficient merit in so doing.

6.2.2. Commercial terms disclosure

In its consultation paper, the HFWG asked the following consultation question about its proposed approach to commercial terms disclosure:

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

Some consultees felt that the proposal to present the financial statements in such a way that investors can calculate fees might not be feasible and may in some instances not be compliant with US GAAP accounting standards. The HFWG acknowledges some of these complexities but still considers that fee transparency is of great importance to investors and that therefore the fund’s annual report should include explanations which allow investors to compare, readily, the fees charged with the description of such fees set out in the fund’s offering document, at least where this is not obvious from the disclosure in the financial statements. The Standards therefore continue to reflect this and have been amended to include guidance on how managers might further enhance fee transparency (e.g. by disclosing total expense ratios or gross vs net return for the period under review). However, this is a topic that could benefit from more detailed industry guidance, such as that which AIMA is able to provide.

6.2.3. Disclosure to lenders/prime brokers/dealers

In its consultation paper, the HFWG asked the following consultation question about its proposed approach to disclosure to lenders/prime brokers/dealers:

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

Some consultees felt that no separate best practice standard is required for lending banks/prime brokers since they are capable of requesting the relevant information to make adequate risk assessments themselves. While the HFWG agrees that counterparties are able to request the required information, it still believes that this topic is important from a financial stability perspective. Therefore, the relevant Standard has been retained.

6.3. Valuation

6.3.1. Segregation of the valuation and the portfolio management function

In its consultation paper, the HFWG asked the following consulation questions in relation to the proposed practices for valuation governance:

- *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?*

The HFWG has received a broad array of consultative feedback on valuation. The disruptions in the financial markets throughout most of 2007 highlighted the need for greater scrutiny of valuation policies and procedures, particularly when hard-to-value assets are involved. The views of the consultees were clearly split: some felt that a completely separate independent valuation provider was essential, while others recognised that competence was essential in valuing a portfolio and that in circumstances where a manager must for that reason be involved in determining asset values, an in-house valuation function that is effectively segregated from the manager's portfolio management function was also best practice.

The HFWG has acknowledged that the ideal way to avoid these conflicts is for the fund governing body to appoint an independent and competent third party when that is feasible. In circumstances where the only way to ensure competent asset valuation is for the hedge fund manager to determine asset values, conflicts need to be managed by ensuring that the in-house valuation function is segregated from the portfolio management function.

6.3.2. Segregation of duties

In its consultation paper, the HFWG raised the following consultation question about the proposed practices around valuation governance:

- *Do the proposals for valuations of illiquid assets provide investors with sufficient confidence that pricing would be done in a fair, dependable and consistent manner?*

Consultees generally supported the proposed best practices for handling hard-to-value assets. One of the key issues raised was that there should be more consistency and comparability of disclosure of hard-to-value assets, for example by applying the FAS 157 fair value hierarchy.[9] The HFWG agrees that this is a useful way to enhance consistency and comparability of disclosure of hard-to-value assets and has added further guidance to the respective (see Standard [8], Chapter 11).

6.4. Risk Management

6.4.1. Risk Framework

In its consultation paper, the HFWG asked the following consultation question regarding the proposed risk framework governance and disclosure standards:

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

Consultees felt broadly happy with the proposed risk framework. The HFWG has added some clarification on the concept of risk tolerance/appetite to the Standards.

6.4.2. Portfolio risk

In its consultation paper, the HFWG asked the following consultation questions regarding the proposed portfolio risk management practices:

- *Please comment on the proposal.*
- *Will the approaches provide investors and counterparties with sufficient understanding and comfort about the handling of risk?*

The HFWG has received responses ranging from saying that the proposals are too prescriptive since each manager deals differently with risk at one end of the spectrum to asking for more prescription as to content, standardisation and frequency of disclosure at the other end. As already mentioned in the disclosure section, standardisation of disclosure is a complex area and given the diversity of the industry is hard to achieve through a prescriptive one-size-fits-all approach.

[9] Separate disclosure of the value attributed to investments (i) which are quoted in an active market, (ii) that rely upon inputs to the valuation process which are observable or derivable from market data, and (iii) that rely on unobserved inputs to the valuation process, for instance the reporting entity's own assumptions about market participant assumptions.

Regarding the frequency of risk (and performance) disclosure, the HFWG has added guidance to portfolio risk disclosure Standard [16] (Chapter 11) to the effect that disclosure should be more frequent (for example, via quarterly newsletters) than through annual reports.

6.4.3. Operational risk

In its consultation paper, the HFWG asked the following consultation questions regarding the proposed best practice standards:

- *Please comment on the proposal.*
- *Will the approaches provide investors and counterparties with sufficient understanding and comfort about the handling of risk?*

Many respondents suggested that legal and regulatory risks should be addressed in an operational risk context. The HFWG agrees and has added a Standard on this (see Standard [17], Chapter 11).

Some consultees also highlighted that hedge fund managers should periodically test their compliance procedures or have them audited by a third party. The HFWG has adopted this as part of Standard [17].

Finally, some of concerns about smaller managers have been raised in this context. Accordingly, the HFWG has clarified in the Standards that, for example, the scale of the required disaster recovery infrastructure is likely to be a function of the size of the manager (see Standard [17], Chapter 11).

6.4.4. Outsourcing risk

In its consultation paper, the HFWG asked the following consultation questions regarding the proposed best practice standards:

- *Please comment on the proposal.*
- *Will the approaches provide investors and counterparties with sufficient understanding and comfort about the handling of risk?*

The main issue for discussion in the context of outsourcing was the requirement to have more than one prime broker. While many consultees agreed that there is a need to ensure diversification of funding and other services, some felt that there is a broader array of issues to consider in the context of prime broker selection than just the diversification aspect. The HFWG is aware that there are various criteria to consider when choosing a prime broker, including efficiency and operational risk considerations. The relevant Standard has therefore been amended to reflect the broader array of issues. The HFWG also acknowledges that it may not be relevant for managers of smaller hedge funds or new market entrants to comply with this requirement, in which case the manager should explain this to investors in accordance with the comply or explain regime.

6.4.5. Fund Governance

In its consultation paper, the HFWG asked the following consultation question regarding its proposed approach to fund governance:

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

It is vital that governance arrangements capable of dealing with potential conflicts between managers and investors are put in place. The nature of these arrangements will depend somewhat on the nature of the investors in the fund. In general, however, the more robust the governance arrangements the more confident investors are likely to be that their interests are protected. Robust governance adopted voluntarily is likely to be particularly reassuring to investors who perceive – rightly or wrongly – that governance requirements are less rigorous in some of the offshore jurisdictions in which many funds are established.

A number of respondents to our Consultation Paper, however, correctly highlighted the distinction, and the separation of functions, between the manager of a hedge fund and that fund's governing body and sought clarification on the question. Broadly speaking, the concern expressed was that the manager could not ensure that certain actions occurred when ultimate responsibility for those actions rested with the fund governing body.

Our view is that while it may be true that a fund governing body has ultimate responsibility for certain actions referred to in the Standards, we consider that the manager will still have a key role to play in the implementation of the Standards. The Standards have therefore been amended where relevant to clarify that where the outcome required by a Standard falls within the remit of the fund governing body rather than the manager, the manager's role in relation to such Standard is to do what it reasonably can to enable and encourage the fund governing body to take the necessary action. This should not detract from the fund governing body’s independent decision-making powers. The manager is merely agreeing to facilitate the effective discharge of the fund governing body's obligations. It has no power to compel the fund governing body to act.

In addition, there will also be cases where the manager does not directly manage the assets of the fund but carries out sub-advisory functions. In such cases the manager will not be in direct contact with the fund governing body. We have not expanded the Standards expressly to address this point. If managers in such situations are unable to comply with any relevant Standards in respect of such funds, they can always explain why they are unable to do so.

A related concern raised during the consultation was that in circumstances where a manager carries out sub-advisory functions for a manager of a hedge fund or is appointed by the operator of a fund platform to manage a particular pool of assets, the manager's position vis-à-vis the fund governing body is likely to be less influential than is the case in a typical hedge fund structure where the manager is the directly appointed investment manager. Whilst the HFWG recognises this, it is nevertheless of the view that inasmuch as a particular Standard requires the manager to do what it reasonably can to enable the fund governing body to achieve a particular outcome and in relation to any Standards which it is not authorised or able to conform with given the terms of its appointment or mandate, then the manager should still be able to comply with that Standard if, in practice, it does what it reasonably can to encourage the relevant pool operator or manager itself to adopt the Standards. Other than to include guidance on this issue, the Standards have not been amended.

The above reflects our view that it is very important that we do not miss the wood for the trees by concentrating unduly on the legal relationships and functions underlying fund governance. The reality is that there needs to be confidence in the relationship between the manager and the fund governing body and the combined product of their respective efforts – namely good investment returns along side effective management of conflicts of interest.

6.5. Shareholder Conduct (including activism)

6.5.1. Prevention of market abuse

In its consultation paper, the HFWG asked the following consultation questions regarding its proposed approach to prevention of market abuse:

- *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"?*

Consultees felt broadly happy with the approach. Some suggested that just disclosing that a manager has a policy to prevent market abuse will not provide much assurance. Rather the policy should be disclosed to investors. Here, the HFWG disagrees. Compliance policies are often seen as proprietary by managers. In addition, this is an area in which law and regulation applies in any event. Therefore, the HFWG believes that confirmation of the existence of a policy is sufficient.

6.5.2. Proxy voting of stock owned

In its consultation paper, the HFWG asked the following consultation question regarding its proposed approach to proxy voting of stock:

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

Most consultees felt that the Standard would enhance market integrity. Some however suggested that the Standards are very prescriptive and could constrain managers. Others again felt that the Standards should go further with respect to regular reporting to clients on how voting rights are exercised. The HFWG is aware that the latter issue has been subject to considerable debate. However, it did not emerge as a recurring theme during the consultation. Therefore, the Standards have remained unchanged.

6.5.3. Disclosure of derivative positions

In its consultation paper, the HFWG asked the following consultation question regarding its proposed approach to fund governance.

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

Many consultees see the need for further discussion in this area. Given the recent issuance of a consultation paper by the FSA on “Disclosure of Contracts for Difference”, the HFWG encourages consultees to submit their views to this FSA consultation, which runs until 12 February 2008.

The HFWG has not explored this issue any further, but expects that the results of the FSA consultation will be of great interest to HFSB and others.

6.5.4. Voting of borrowed stock

In its consultation paper, the HFWG asked the following consultation question in relation to its proposed approach to voting of borrowed stock:

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

Whilst some consultees suggested that wider debate would be useful, many others did not have strong views on this issue. Of those who had a view, there was broad agreement that the issue should not be addressed only in the context of hedge funds. The feedback also indicated some of the complexities around this issue. In substance, the Standard has not been changed.

7. Becoming a signatory

7.1. Publicising a comply or explain decision

Since this is not an exercise in prescription, it was natural for many respondents to raise practical questions about how conformity with the Standards under the comply or explain regime will be made known. This chapter sets out the procedure and examples of the documentation can be found at Appendix C (*Signatory Pack*). One of the simplest and most efficient ways of declaring registration with HFSB and conformity with the Standards is likely to be through a publicly accessible website. Alternatively, or in addition, this can be stated on a manager's marketing materials. As to conformity, managers can either comply with individual Standards or explain why they are not complying.

Two important questions arise:

1. To whom should the explanation be given? The approach here is the same for any other area of disclosure: namely, the explanation is owed to the investor and any other relevant stakeholder on whose behalf the Standard has been created.
2. What is the nature of the explanation that should be given? Clearly a statement which merely says "We choose not to comply" does not constitute an explanation: it is merely a statement. The best way of approaching this is that, starting with the requirements of compliance, the explanation should be capable of being understood and accepted as reasonable by the person to whom it is made.

7.2. Signing up

Managers wishing to become signatories to the Standards may obtain a simple form from HFSB. The form will be part of a Signatory Pack which will also contain:

- An Explanatory Memorandum for Signatories;
- A Conformity Statement; and
- An Explanatory Memorandum describing the nature of HFSB and the roles of its interim Trustees and Trustees.

Copies of the full set of these documents can be found at Appendix C (*Signatory Pack*) and on the HFSB website.

As a signatory, a manager will be expected to:

- Adopt the comply or explain approach described in this Report after a period intended to enable it to assess the consequences of the Standards for the operation of its business
- Contribute to funding HFSB. Details have yet to be worked out, but the amount will be related to the number of signatories and will recognise the position of smaller firms
- From the date on which it adopts the comply or explain approach described in this Report, show for the benefit of investors on its marketing materials and/or website that it is a signatory (HFSB will provide a logo or similar rubric)
- Do what it reasonably can to ensure that the fact that it is a signatory to the Standards is communicated to investors and prospective investors in hedge funds managed or advised by it through the prospectuses or offering memoranda of such funds (either

when such documents are first published or, in the case of existing documents, next updated).

7.3. Comply or explain

There are several important reasons why we chose a comply or explain approach:

- The industry is very diverse by size, strategy and nature of firm. A "comply only" regime would have required the Standards to be far more detailed and lengthy to try to cater for all potential signatories. As it is, we have been able to pitch the Standards at a relatively high level.
- A "comply only" regime would have been more prescriptive. Instead, the comply or explain regime rests on disclosure and needs only minimum prescription.
- The "explain" option enabled us to cover a majority of circumstances for a majority of firms, while recognising idiosyncrasies.
- Comply or explain accommodates the dynamism of firms without needing constantly to change the Standards. The HFWG felt this was important for such a fast moving industry.
- The comply or explain approach may be less well understood outside the UK, but it has the advantage of allowing non-UK managers who become signatories to the Standards the flexibility to "explain" in the event that any action required by the Standards is inconsistent with local law and regulation.

7.4. Market discipline and conformity

We appreciate that there can be no guarantee that those who say they will conform with the Standards in terms of comply or explain will always do so. But the same could be said of a statutory regime. Moreover, it does not follow that an industry-led regime such as the one recommended here lacks incentives to conform. Responses to the consultation show that a wide range of market participants will be prepared to take into account whether a manager is a signatory to the Standards in assessing that manager. Although the fact that a manager has signed-up to the Standards is not a substitute for due diligence, this element of market discipline should be powerful.

There are several reasons why it is hoped that market forces are likely to encourage conformity and indeed compliance. These are:

1. **Peer group pressure**
   The Standards are based on enlightened self-interest. They have been devised by leading practitioners to enhance the confidence that people have in the activities of individual managers and the sector as a whole. So managers with good intentions, wishing to appear publicly as responsible, will either comply or explain. This will place peer group pressure on others to conform. Failure to do so would be bad for business and confidence when compared with leading firms in the sector which have decided to adopt the Standards.

2. **Market pressure from investors**
   Many of the Standards have been devised with investors in mind and reflect their legitimate interests. It is to be expected that such stakeholders will take a close interest in the Standards and seek to establish whether a particular firm complies with the Standards and, if not, why.
3. **Continued relevance**
   The continued relevance of the Standards will be essential to ensuring continuing compliance or explanation. They will therefore need to be reviewed and updated on an ongoing basis to ensure that they remain relevant and both adapt to changes in the environment and reflect experience of the FSA's interpretation of what is required by the FSA's Principles. The mechanisms to achieve this are outlined in Chapter 8 (*The Hedge Fund Standards Board*).

It is very important, therefore, that all parties play their part in exercising market discipline if confidence in the Standards is to be preserved.

- **Managers** who are signatories need to comply or explain and will wish to exert pressure on firms which they feel are not operating to the same standards.
- **Investors, lenders and suppliers** need to give weight to conformity when assessing managers.
- **Regulators** may give some weight to conformity with the Standards or the spirit of them.
- **The Board of Trustees** must in accordance with their mandate ensure that the Standards are maintained and therefore command confidence.

7.5. Regulatory and legal status of the Standards

An important set of questions which arose from the consultation concerned the regulatory and legal status of the Standards and their impact on the legal and regulatory position of managers. Here we outline the basis on which managers can decide.

- Whether becoming a signatory to the Standards is likely to be beneficial for an individual firm,
- Whether the publication and adoption of the Standards is likely to benefit the UK hedge fund management industry as a whole,
- The potential UK and US regulatory and legal liability associated with the publication and adoption of the Standards.

Full treatment of these questions is at Appendix D (*Regulatory and legal status of the Standards*).

7.5.1. The regulatory status of the Standards

The FSA is driving towards more Principles-based regulation (MPBR). Under MPBR the FSA, recognising that regulated firms are better placed to determine the processes that will achieve the desired regulatory outcomes, will in effect rely on high-level, broadly stated principles to articulate the desired outcomes and then leave regulated firms to decide for themselves how to achieve those outcomes.

The FSA envisages a greater role for sector-specific industry guidance in the new world of MPBR. There are two types of industry guidance for these purposes: guidance that has been confirmed by the FSA, and other (unconfirmed) guidance. The HFSB Standards will be unconfirmed guidance.

FSA confirmed industry guidance will be accorded "sturdy breakwater" status. This means that the FSA will not take action against any regulated firm that has adhered to confirmed industry guidance in force at the relevant time. However, the absence of "sturdy breakwater" status for the Standards does not mean that we believe they are in any way regarded as "sub-standard" for their purpose. Real practical protection for managers should, we feel, be provided in that where all relevant firms were acting on the basis that those standards were reasonable, this should in our view inform any proper interpretation of what the FSA Principles required.

There are two main reasons why we have not sought FSA confirmed guidance status for the Standards. First, the purpose of the Standards is to promulgate what we consider to be best practice in the UK hedge fund management industry at a benchmark level reflecting the standard of reasonable skill and care we consider is likely to be applied by the English courts in civil negligence claims. In contrast, the FSA consistently describes its Principles as setting the minimum standards to which regulated firms should adhere.

Second, the comply or explain approach recognises the diversity of the hedge fund management sector. We believe that a process to accommodate this diversity, rather than a "one size fits all" approach, is appropriate as being consistent with the spirit of MPBR; this inherent diversity is, however, in our view unlikely to lend itself to the FSA confirmation process.

7.5.2. The risks of not having the Standards

Given the FSA's increasing scrutiny of hedge fund managers, for the industry simply to do nothing must give rise to a risk that the FSA (or any other regulator) might at some future date impose additional regulatory requirements that the industry considers unpalatable. This could involve the creation of new FSA rules or the issue of informal guidance on the application of the Principles or other FSA rules to hedge fund managers.

Further, without best practice standards such as those contained in this Report, there is, in our view, a risk of greater uncertainty as to the standards of conduct by which hedge fund managers would be judged in any FSA enforcement action under the FSA Principles. Thus there is value in the industry seeking to influence the way in which those standards are assessed through appropriately framed guidance and it is hoped that the existence of the Standards and their continued evolution will contribute to this.

7.5.3. The Standards and legal claims

Under English law, claims in contract and tort against managers may arise in several ways. Conformity with the Standards, however, whether through compliance or an explanation of non-compliance, should help to protect a manager from claims. It follows, of course, that hedge fund managers will need to do what they have asserted they will do in order to avoid potential liability. This is explored further in Appendix D (*Regulatory and legal status of the Standards*).

7.5.4. The status of the Standards in the US and jurisdictions other than England and Wales

In general, the legal status of the Standards in other jurisdictions would depend on the local regulatory regime and the extent to which that regime regards the Standards as best practice. The US position is analysed in Appendix D (*Regulatory and legal status of the Standards*).

8. The Hedge Fund Standards Board

A crucial next step in bringing the Standards into force is establishing HFSB. In this chapter we look at:

- The nature of HFSB
- The timetable for setting it up
- The mandate of the Board of Trustees
- The profile of the Trustees.

These issues are discussed in full in the "Hedge Fund Standards Board, HFSB, Its Interim Trustees and Trustees, Explanatory Memorandum" in the "Signatory Pack" at Appendix C.

8.1. The nature of HFSB

The vehicle will be a company limited by guarantee and incorporated in England and Wales. The directors of the company will be the Trustees who will act as guardians or custodians of the Standards. They will be required to promote the objectives of the company as described in its mandate (see Section 8.3 below), having regard to the interests of all stakeholders.

8.2. The timetable for setting up HFSB

Following the publication of this Report on 22 January 2008 there will be an interim phase of some three to four months whilst arrangements for HFSB are finalised and the permanent Board of Trustees are appointed. During that interim phase each of the 14 members of the HFWG, being the initial signatories, will act as "interim" Trustees along with Christopher Fawcett and Sir Andrew Large. Sir Andrew will be interim chairman until a permanent chairman is appointed. The "interim" Trustees will adhere to the mandate for the Trustees (see Section 8.3. below).

During the second quarter of 2008 the date will be announced when the arrangements for the Board of Trustees will be formally in place, along with the names of those appointed, including the chairman. This will correspond to the end of the interim period.

Other hedge fund managers considering becoming signatories should feel free in the meantime to contact Karen Williams at admin@hfsb.org. The signatory pack is at Appendix C and on the HFSB website at http://www.hfsb.org.

8.3. The mandate of the Board of Trustees

The mandate gives the Board of Trustees specific duties to:

- Act as **guardian** or **custodian** of the Standards
- Limit the company's role so that it **will not act as a regulator** or **interpose** itself in any way between managers and regulators
- Produce an **annual report** on conformity with the Standards by the industry

- Ensure it is **not a trade association**, which is the role of AIMA. The Board of Trustees and AIMA have agreed to cooperate closely. Chapter 10 of the Report deals with AIMA's role and cooperation between the Board of Trustees and AIMA in more depth
- Maintain a **register of signatory firms** available for public inspection
- **Maintain Standards** which:
  - are up to date
  - are set at a high standard of conduct
  - meet the aspirations and needs of the managers
  - reflect the expectations of investors
  - meet the requirements of public policy
  - respond to changes in practice and expectation
  - are iterated and revised in the case of existing standards and so that new standards are developed where gaps are identified
- **Maintain links with stakeholders**, including managers, industry users and suppliers, AIMA, the FSA and other regulatory bodies, both within and outside the UK
- **Consider other best practice** standards which may be published or promulgated in jurisdictions outside the UK
- Recognise that the **industry operates on a global basis** and **evaluate opportunities for, and impediments to, convergence**
- To retain a **Board of Trustees** whose members:
  - have skills and experience in a wide variety of sectors
  - are of independent mind
  - have skills and experience in governance matters
  - are of high standing and capable of commanding respect
  - have experience and understanding of the international dimension
  - have a personal commitment to the success and reputation of the industry
  - are capable of collectively fulfilling the mandate
- To **consult publicly on any proposed changes to the mandate** with all relevant stakeholders

8.4. The profile of the Trustees

Trustees will be appointed by the interim Trustees informed by the above mandate and quality requirements in the knowledge that a failure to fulfil those requirements will undermine confidence in the process.

Work is underway to select and appoint a permanent Chairman of the Trustees. Candidates will be appraised according to the mandate's requirements. Two particular considerations are an ability to understand the hedge fund sector, and an independence of mind to help ensure that issues raised by interested parties are taken into account.

There have been suggestions that there should be a large number of independents on the Board of Trustees. However, it is the HFWG's view that it is essential that the Standards command the continued respect of those on whom they bear, and who have constructed them. In the HFWG's view, therefore, practitioners are key. As indicated in relation to the mandate, HFSB's role is to be a guardian or custodian of the Standards, not a regulator. The FSA in the UK and other regulators overseas are responsible for regulation to protect the public interest.

There will be no prescribed groups from which the Board of Trustees should be drawn and only the Board of Trustees will be able to make nominations. However, for practical reasons the number of Trustees will be limited to 12 (although there will be 16 interim Trustees).

The Board of Trustees will nominate and appoint new Trustees. Any such appointments will be subject to approval by the signatories to the Standards at an annual meeting of signatories. Each appointment will be subject to re-election by signatories at the minimum every three years, as is common for appointments to publicly listed companies in the UK.

9. The global dimension

9.1. Encouraging global convergence

Implementing and maintaining the Standards has an inescapable global dimension. The hedge fund industry operates worldwide and one of the purposes of this exercise is to encourage global convergence of standards governing the industry. Another is to help promote financial stability. Here we discuss four facets of the global dimension:

- The general relevance of the Standards for managers operating from jurisdictions other than the UK
- The particular question of the relevance of the Standards for managers based in the US, notably in the light of the forthcoming report from the US President's Working Group
- The longer-term issues facing the Board of Trustees
- Financial stability (for a fuller discussion of this issue, see Appendix H (*Financial stability dimension*)).

9.2. Relevance for other jurisdictions

The central point here is the location of the manager. The Standards are anchored in the UK insofar as they represent the best efforts of the HFWG to articulate how the FSA's Principles, which apply to all FSA authorised managers, can best be given life in the hedge fund management arena. The Standards are also voluntary and have been designed to help give confidence to investors and other users of the industry. However, the FSA's Principles are generally regarded as being determinants of good business practice almost everywhere even though they only have legal force in the UK.

Viewed therefore from the perspective of investors or lenders, compliance with these Standards ought to be of comfort wherever the hedge fund manager is situated, regardless of whether a particular jurisdiction has a regulatory regime. Obviously, it remains to be seen to what extent this will prove to be the case.

Clearly, if there are elements of the Standards which for some reason run counter to local regulatory requirements, those seeking to adhere to the Standards would need to explain rather than comply with the Standards as they relate to activity undertaken in those jurisdictions. But it is not apparent where this is likely to be a major issue in practice. Moreover, we would hope that the Standards might assist supervisors in jurisdictions where the regulatory approach is undecided. Informal feedback from supervisors in several jurisdictions has welcomed the Standards basically for this reason.

Accordingly, HFSB will welcome approaches from any non-UK based manager who considers that becoming a signatory would be of value to them.

9.3. The US situation

The situation is different in the US. Managers based in the US are engaged in a parallel process to ours under the auspices of the President's Working Group (the "PWG") in developing best practice standards.

The PWG has two separate committees, one of which has been directed to consider the managers' relations with hedge funds, and the other investors' relations with hedge funds. They are expected to produce their comment papers soon. These will contain standards of best practice to be considered by managers and investors. In the HFWG's view, any differences of approach will be healthy and promote well-informed discussion.

It will be valuable for HFSB to review these findings and ascertain where convergence may be desirable between standards applicable to managers. It will also be useful to identify where convergence may be possible between the Standards as they affect investors in hedge funds. We have discussed above the reliance on market pressures – rather than regulatory intervention – to encourage conformity by managers with the Standards. US best practice standards affecting investors may therefore have implications for the UK process. The UK does not at this stage have an industry-led investor group addressing this area which could represent investors with many types of fiduciary duties: fund of funds, endowment, pension funds, and others.

9.4. The longer term

The Board of Trustees will need to respond to these important parallel initiatives to understand better where convergence is practical and where it is not. This in turn could lead to a gradual development of standards for this global industry which will command respect generally and apply to managers in all major jurisdictions.

In the first instance, the Board of Trustees may wish to consider areas of convergence, such as valuation and liquidity risk management, which could influence financial stability – an issue of global concern. Of course, these areas apply to the entire financial industry, not just hedge funds. But many of the issues we have tackled, though based on hedge fund experience, are relevant in other areas of the financial services industry including investment banking and others. Lessons from this area may have a wider significance, therefore, and the hedge fund sector is willing and able through AIMA and HFSB, to engage with the appropriate authorities and other practitioners for whom these areas are important. It should be emphasised however that changes to the Standards will not take place rapidly and will involve a full consultation exercise.

9.5. Financial stability

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

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

However, hedge funds occupy a particular position of size and influence and accordingly the question of concentrations within the hedge fund sector remains a significant point. Although there is little evidence that hedge funds have withdrawn en masse from their positions during, or as a result, of the difficult credit conditions which began in July 2007, firms and their supervisors need to pay significant attention to risk management. In particular, they need to look at liquidity risk management and stress testing and scenario planning.

A fuller discussion of this important topic can be found at Appendix H (*Financial stability dimension*).

10. Relationship with other bodies

Many bodies have a legitimate say in the future of hedge funds and in producing this report our attention has been drawn to a wide range of materials from many sources. One of the most prominent voices in the industry is AIMA and cooperation between HFSB and AIMA will be central to the maintenance and development of the Standards.

10.1. The Role of AIMA

AIMA's role was raised directly and indirectly during the consultation. The position is that AIMA endorses the approach of the HFWG and agrees that this initiative is the right approach for the industry. Acknowledging the need for cooperation and convergence of industry standards, AIMA has agreed to work closely with HFSB to develop the Standards that have been created for the UK hedge fund industry and which are founded on the FSA Principles. The HFWG initiative has demonstrated that the industry acknowledges its responsibility to address the concerns raised about it and to build on and complement AIMA's efforts to enhance industry practices. Indeed, AIMA is well placed to play an important role in the convergence of global hedge fund standards.

Against that background, the Board of Trustees will be responsible for the evolution of the Standards though they will liaise with AIMA to ensure that the industry is properly consulted. It is acknowledged that industry participants may need more detailed clarifications (for example, guidelines and detailed guidance) over a number of these Standards. Recommendations already exist in areas such as valuation. The Trustees and AIMA will work to mesh the Standards and AIMA materials seamlessly. New or more detailed materials may be requested in other areas. In those cases, AIMA may seek to produce guidance to dovetail with the relevant Standard after due consultation with its members.

In endorsing HFSB's approach, AIMA supports the following in particular:

- An industry-led initiative for proposing and drafting the Standards
- A consultation embracing a wide range of industry participants to ensure relevance and applicability of the Standards
- A comply or explain regime which takes existing industry guidance forward into a more demanding format which retains potential for innovation and change while requiring industry participants to decide how fully they wish to comply with the Standards
- A regime with strong emphasis on disclosure
- A regime capable of being applied to managers of all sizes and strategies; and
- A credible process based around the Board of Trustees for development of the Standards to ensure continued relevance

To reinforce this commitment, HFSB and AIMA have agreed that AIMA's Chairman will serve as an interim Trustee from the date of this document. In addition, HFSB looks forward to working with AIMA as it will assist in encouraging hedge fund managers to become signatories to the process.

HFSB, also looks forward to working with AIMA to foster cooperation and convergence of industry practices globally. HFSB and AIMA are therefore in discussion about the location of, and the physical support for, the secretariat of HFSB to maximise the synergies and cooperation between the two organisations.

10.2. Sector information

Accurate and comprehensive information about the hedge fund industry as a whole is hard to find. There are good reasons for this. The industry has developed fast; the roots of the industry are closer to the closed world of private banking than they are to mainstream finance; the firms are still mostly privately owned; and there has been little incentive to create the necessary information.

Although sources of information do exist, access may be difficult and their scope and accuracy are uncertain. Moreover, definitional issues arise both in relation to identifying which firms are hedge funds, and as regards to investment strategies. For all these reasons, the paucity of suitable data is out of keeping with the importance of the industry.

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

10.2.1. Information about the sector

HFSB and AIMA will set up a working party to consider how to make more information about the hedge fund industry publicly available. This will include basic information about the hedge fund industry, such as types of funds, definition of strategies and so on. The working party will also explore ways to make more dynamic information available (industry statistics, for example assets under management). This content will be added to the HFSB website over the coming months.

10.2.2. Information on individual firms and financial promotion

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

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

10.3. Education

In its consultation, the HFWG asked the following consultation question:

- *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?*

A number of consultees took great interest in this topic and stressed the importance of adequate educational training. Some highlighted existing curricula at various universities, others pointed in the direction of the Chartered Alternative Investment Analyst Association (which was cofounded by AIMA), the Chartered Financial Analyst qualification and bodies such as the Securities and Investment Institute. The Board of Trustees will work with AIMA to determine what more needs to be done in this arena.

10.4. Other materials and relationship with HFWG's Standards

An issue which emerged during the consultation was how other materials relate to the Standards. It is worth remembering that our approach has been to:

- Create a series of linked best practice standards which collectively provide guidance to managers on how they approach their obligation to comply with the FSA Principles
- Be non-prescriptive at a relatively high level, leaving significant discretion to managers about what they disclose bearing in mind the requirements of those to whom the disclosures are made
- Rely or build on materials created by others such as AIMA, the International Organisation of Securities Commissions (IOSCO) and others wherever possible to avoid reinventing wheels unnecessarily
- Frame the Standards in a consistent manner, stating:
  - the issue addressed;
  - the relevant FSA Principles;
  - the party for whom the issue matters;
  - the disclosures that should be made to the relevant parties;
  - the governance needed to deliver the intended output; and
  - and at a similar level of granularity.

A wide range of material covering a great deal of the industry's activity has therefore been treated consistently. Some of the materials put together by, for example, AIMA relate closely to the Standards in particular areas. Their detailed guidance on valuation, for example, fits in that way.

The table below provides an overview of the vast array of materials produced by AIMA and others.

Type of material	Examples
Overarching guidance	▪ AIMA Guide to Sound Practices for European Hedge Fund Managers (2007) ▪ MFA's Sound Practices for Hedge Fund Managers (2007)
Valuation	▪ AIMA's Guide to Sound Practices for Hedge Fund Valuation (2007) ▪ IOSCO's Principles for the Valuation of Hedge Fund Portfolios
Governance	▪ AIMA's Offshore Alternative Fund Director's Guide (2008) ▪ The AIC Code of Corporate Governance
Other	▪ AIMA Anti Money Laundering Matrix ▪ AIMA Guidance Notes: Market Ethics ▪ AIMA Guidance Notes: MiFID ▪ AIMA's Industry Guidance on Side Letters ▪ AIMA's Illustrative Questionnaires for Due Diligence (for example, by prime brokers, hedge fund administrators)

11. HFSB Standards

Introduction

HFWG/HFSB
Although the Standards set out below have been formulated by the HFWG, they refer to HFSB because going forward the "ownership" of the Standards will rest with that organisation.

How to read the Standards
The Standards are set out in a consistent format in blue shaded boxes throughout this document. The differentiated formatting of the text within the boxes reflects the different nature of the content:

- The actual Standards **(in bold)**
- Additional guidance and examples which are intended to assist and illustrate how compliance might be achieved (in normal text)
- Explanations and comments *(in italics)*.

Illustration

- **The actual Standard is set out in bold text**
  - **- Lists of relevant sub-items which form part of the Standard are set out in bold text.**

  Guidance on the Standard (and references to useful additional guidance, e.g. materials published by AIMA and IOSCO) and examples of how the Standard might be complied with are set out in normal text.

  Additional explanation and commentary to enhance understanding is set out in italics.

It is the Standards (in bold type) with which hedge fund manager signatories to the Standards are required to conform on a comply or explain basis. The Guidance and examples (in normal and italic type) are intended only to assist managers in complying with the Standards.

Applicability of the Standards to particular types of management activity

We should emphasise that the Standards have been designed so as to apply to fund managers solely in respect of their management activities in relation to hedge funds for which they act as the investment manager. They do not apply to other activities including, by way of example, management activities in relation to segregated accounts or fund of hedge funds although certain of the Standards might, with or without adaptation, be appropriate for hedge fund managers to utilise in carrying out those other activities.

We would have no objection if a hedge fund manager, for the avoidance of any doubt, specified in its Disclosure Statement and on its website any areas of its business to which the Standards are not applicable.

In circumstances where a manager carries out sub-advisory functions for a manager of a hedge fund or is appointed by the operator of a fund platform to manage a particular pool of assets, it is recognised that the manager's position vis-à-vis the fund governing body is likely to be less influential than is the case in a typical hedge fund structure where the manager is the directly appointed investment manager. Nevertheless, in as much as a particular Standard requires the manager to do what it reasonably can to enable the fund governing body to achieve a particular outcome and in relation to any Standards which it is not authorised or able to conform with given the terms of its appointment or mandate, then the manager should still be able to comply with that Standard if, in practice, it encourages the relevant pool operator or manager itself to adopt the Standards.

Certain of the Standards may also be capable of application to other areas of the asset management industry. If participants in those areas find any of the Standards helpful and wish to adopt or adapt them for their circumstances then they are of course free to do so and we would welcome that.

Applicability to smaller managers
The HFWG encourages broad adoption of the Standards by fund managers involved in hedge fund management irrespective of their size and the stage of development of their firms. Although fund managers who founded the HFWG may be considered more “established”, each having more than US$ 3 billion under management, the Standards are equally capable of being adopted by smaller as well as larger firms.

During the consultation, some felt that established managers may find it easier at the outset to comply or take steps to achieve compliance or otherwise explain their approach than a smaller manager or start-up. A smaller manager could, for example, face resource constraints in producing more detailed documentation to explain its approach to investors on broader comply or explain issues.

The HFWG has noted this concern and has added acknowledgements in some Standards which take account of specific challenges facing smaller managers. Moreover an explanation from a manager as to why it is unable to comply with a particular Standard may be considered entirely appropriate in the circumstances.

Disclosure in the fund's offering documents
Various of the Standards require a manager to do what it reasonably can to enable and encourage the fund governing body to make certain disclosures in the fund's offering documents. For the avoidance of doubt, HFSB expects this to apply only to current and future offering documents. To the extent that a fund's current offering documents do not contain the required disclosure, we would expect managers to do what they reasonably can to enable and encourage fund governing bodies to update such offering documents to include the relevant disclosures as soon as practicable in order to comply with the relevant Standard.

However, a manager may of course choose to not comply with such Standard but rather to explain that, for example, on the grounds of cost, it intends to encourage the fund governing body to wait until the fund's offering documents are next updated for some other reason. So far as old offering documents are concerned where there is no outstanding offer of securities being made, a manager can effectively ignore the Standards relating to offering document disclosure since the relevant offer closed before the Standards had been adopted.

Disclosure in the manager's own marketing materials
Various of the Standards require a manager to make certain disclosures in its "marketing materials". In recognition of the fact that a manager's marketing materials will normally comprise various documents, sometimes including very short "teasers" or "flyers", the Standards should not be interpreted as requiring the same information to be included in each such document. Rather, such documents should when taken as a whole, and together with the fund's offering documents, contain the required disclosures and it is for the manager to decide which disclosures ought properly to be made in which documents with a view to ensuring that investors and prospective investors are provided with the information they would reasonably require in order to make a properly informed investment decision. It follows that where in the Standards a disclosure is required in the manager's marketing materials this requirement will be met if disclosure is made in the fund's offering documents.

FSA Principles
The FSA Principles relevant to each of the Standards are set out below. It should be noted that for UK regulatory purposes the references in the FSA's Principles to a firm's "customer" or "client" are in this context to be read as a reference to the fund managed by the manager and not to the investors in the fund. Nevertheless, HFSB believes that managers will wish to consider the interests of the investors in the funds and to do what they reasonably can with a view to ensuring that the benefits of outcomes sought by the Standards flow through to investors.

A. Disclosure to investors and counterparties [1]-[4]

There are several areas where adequate disclosure is required:

- Investment policy and associated risks, which relates to disclosure to investors of the fund's investment strategy and the risks involved in an investment in the fund (Standard [1])
- Commercial policy, which relates to disclosure of the commercial terms on which the manager has agreed to manage the fund and on which investors will invest (Standard [2])
- Performance measurement (Standard [3])
- Counterparty disclosures, such as to prime brokers (Standard [4]).

Investment policy and risk disclosure [1]

Investment policies and strategies and related risks can vary significantly between funds. Ensuring that these are carefully explained in a fund's offering documents or the hedge fund manager's own marketing materials is therefore vital to enable investors to make well-informed decisions when investing and monitoring investments. The HFWG 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?

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) Communications 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.

Investment policy and risk disclosure - Standards and Guidance [1][10]

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to include an appropriate level of disclosure (taking into account the identity and sophistication of potential investors) and explanation in the fund's offering documents of the fund's investment policy/strategy and associated risks.**

  HFSB envisages that in most circumstances such disclosure would, amongst other things, include:
  – an appropriate description of the investment strategies and techniques employed and prominent disclosure of the risks involved (Standards [16], [18], [20] and [22] also deal with risk disclosure);
  – general details of the investments and instruments (including, for example, derivatives) likely to be included in the fund's portfolio;
  – details of any investment restrictions or guidelines and of the procedures the manager will follow in respect of any breaches;
  – an explanation of the circumstances in which the fund may use leverage, the

[10] In conforming to these best practice standards, managers may wish to consult the guidance contained in MFA 2007 Sound Practices for Hedge Fund Managers (e.g. 2.2, 2.3, 2.4, 2.5) as well as the CFA Institute's Asset Manager Code of Conduct –Selection F (Disclosure) and AIMA´s Guide to Sound Practices for European Hedge Fund Managers (2007).

sources of such leverage and details of any restrictions on the use of leverage; and
- prominent disclosure of the risks involved in employing leverage.

- **A hedge fund manager should ensure that its own marketing materials refer to the fund's offering documents and make it clear that investors should rely only on the fund's offering documents when making any decision to invest.**

  It is recognised that incidental image or other short form marketing materials may not include such a cross reference to the fund's offering documents.

- **A hedge fund manager should carefully consider the appropriate mechanism, given the nature of potential investors, for changing the fund's stated investment policy/strategy and advise the fund governing body accordingly. This may range from prior investor/fund governing body consent, to consultation to mere notification. Once the fund governing body has determined the appropriate mechanism, the manager should do what it reasonably can to enable and encourage the fund governing body to disclose such mechanism appropriately in the fund's offering documents.**

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to include in the fund's annual report a statement explaining how the fund has invested its assets during the relevant period in accordance with its published investment policy.**

  HFSB envisages that such statement will comprise a high-level factual explanation as to how the fund has invested its assets during the period. It is not intended to be a review or confirmation of compliance with the fund's investment policy.

Commercial terms disclosure [2]

The commercial terms of hedge funds are very important to investors. The terms include, for example, 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 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?

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) Communications with clients – a firm must pay due regard to the information needs of its clients, and communicate information in 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.

Commercial terms disclosure – Standards and Guidance [2][11]

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to disclose the commercial terms applicable to a particular hedge fund in sufficient detail and with sufficient prominence (taking into account the identity and sophistication of potential investors) in the fund's offering documents.**

  HFSB envisages that in most circumstances such disclosure would, amongst other things, 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);

[11] Managers may wish to consult further guidance, as set out by MFA's 2007 Sound Practices for Hedge Fund Managers (2.6) and GIPS guidance on disclosure of fees and cost (section F), www.gipsstandards.org

    - the basis of calculation for any base management fee and details of the nature of any expenses which may be payable or reimbursed by the fund to the manager;
    - to the extent possible, the amount of and/or method of calculating the periodic fees payable to the fund's other service providers; and
    - if applicable, the fact that the fees and expenses payable to service providers may change.
  - termination rights:
    - details of the circumstances in which the fund is entitled to terminate the manager's appointment and the terms (e.g. in relation to termination fees) of such termination.
  - exit terms (in the case of open-ended funds):
    - the period of notice investors are required to give to redeem their investment in the fund;
    - details of any redemption penalties;
    - any "lock-up" periods during which the investor will be unable to redeem its investment in the fund and any limits on the extent of redemptions on any redemption date (i.e. redemption "gates"); and
    - circumstances in which normal redemption mechanics might not apply or may be suspended, if any.

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to disclose any material changes to such commercial terms to investors.**

- **A hedge fund manager should disclose the existence of side letters which contain "material terms"[12], and the nature of such terms. A hedge fund manager is not required to disclose the existence of side letters which contain no material terms.**

  Further guidance on this Standard is contained in AIMA's Industry Guidance Note on Side Letters.[13]

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to disclose in the fund's financial statements the management and performance fees charged. This includes explanations in the annual report which allow investors to compare, readily, the fees charged**

[12] "Any term the effect of which might reasonably be expected to be to provide an investor with more favourable treatment than other holders of the same class of share or interest which enhances that investor's ability either (i) to redeem shares or interests of that class or (ii) to make a determination as to whether to redeem shares or interests of that class, and which in either case might, therefore, reasonably be expected to put other holders of shares or interests of that class who are in the same position at a material disadvantage in connection with the exercise of their redemptions rights."

[13] AIMA's Industry Guidance Note on Side Letters and Supplement No. 1 thereto: http://www.aima.org/uploads/AIMAIndustryguidanceNoteSideLettersMembers.pdf

with the description of such fees set out in the fund's offering documents where this is not obvious from the disclosure in the financial statements.

For example, the categories and captions in the fund's financial statements might correspond to those used in the fund's offering documents so they can be easily compared.

Managers might also consider disclosure of a total expense ratio (TER) or gross vs. net return for the period under review.

- **On the establishment of a fund, a hedge fund manager should liaise with the fund's administrator to ensure that the methodology for calculating fees payable to the manager (and in particular performance fees) is agreed in advance. A hedge fund manager should also do what it reasonably can to enable and encourage the fund governing body to ensure that such methodology is accurately described in the fund's offering documents.**

Performance measurement [3]

Accurate and consistent reporting of investment performance enables investors to make well-informed judgments about their investments and allows them to compare different managers and hold them to account. The Global Investment Performance Standards (GIPS)[14] 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 identified the following issue:

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

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) Communications 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.

Performance measurement - Standards and Guidance [3]

- **A hedge fund manager should, in cases where, in its view, the fund has material exposure to hard-to-value assets, ensure that any disclosure in its own marketing materials relating to the fund's performance is accompanied by a reference to any factors which may be material to the robustness of the performance calculation. A hedge fund manager should also do what it reasonably can to enable and encourage the fund governing body to include similar references in the fund's offering documents where they include details of the fund's performance.**

  Such factors might, amongst others, include:
  - the percentage of the portfolio invested in what the manager considers to be hard-to-value assets;
  - the method used in valuing assets which the manager considers to be hard-to-value; and
  - the use of side pockets.

HFSB welcomes the initiative of GIPS to review the applicability of their existing principles to hedge funds.

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[14] Administered by CFA Institute (www.gipsstandards.org).

Disclosure to lenders/prime brokers/dealers [4]

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 assessments.[15] 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 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 these recommended practices.

The HFWG identified the following issues 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?

FSA Principles

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

[15] 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. crmpolicygroup.org

Disclosure to lenders/prime brokers/dealers Standards and Guidance [4]

- **A hedge fund manager should, subject to obtaining the consent of the fund’s governing body, provide, or do what it reasonably can to enable and encourage the fund's administrator to provide, any agreed information reports to the fund's counterparties in a timely manner.**

B. Valuation [5]-[9]

Valuation is the process of determining the value of a hedge fund's portfolio at a given time. While 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 outcomes that derive from the valuation process. It follows that investors need to be informed about the valuation process and have confidence in its breadth and robustness. For example, the valuation process should be seen in the context of the depth of the market in the relevant asset class. As hedge funds are significant users of complex assets, where depth of markets may be uncertain, this needs to be borne in mind when considering valuations of those underlying assets.

The liquidity crisis

The credit crunch which began in summer 2007 has demonstrated that the valuation of hard-to-value assets is clearly one of the most significant issues affecting confidence in the financial industry today. We hope that the Standards we have drawn up for hedge funds will contribute to best practice in this area. But the issues apply to the whole financial services industry. The inherent problem is the inadequacy of any single number to answer the question of what an asset is worth, what could it be sold for, over what period etc. This is one of the most pressing areas on which progress is needed in the months ahead and it is just as pressing for investment banking, proprietary trading desks, commercial banks and money market funds. The hedge fund sector stands ready to play its part in this debate, which needs practitioners, lenders, third parties, investors and the accountancy profession to come together if progress towards better understanding and better transparency and portrayal of valuations is to be made.

For open-ended funds, the valuation is the basis for subscriptions to and redemptions from hedge funds by investors. For all hedge funds, it measures the hedge fund's performance and affects the compensation of the hedge fund manager. Here, we identify two sets of issues in relation to valuation: segregation of the valuation and portfolio management functions and how to deal with hard-to-value assets.[16]

[16] 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 detail on specific valuation themes. The HFWG recommends both as further guidance for hedge fund managers in formulating their valuation approach. Links: http://aima.org/uploads/execsummaryAIMAGuidesSPforHFValuation2007.pdf (the full text is only available in hard copy), http://www.iosco.org/library/pubdocs/pdf/iOSCOPD240.pdf

Segregation of functions in valuation – Governance [5]+[6]

For some hedge funds, a third party 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 valuation process. Such an outcome is particularly likely where a hedge fund invests in hard-to-value assets or complex derivatives and the third party lacks sufficient expertise in that area.

By contrast, other hedge funds 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. However, such recourse to in-house specialist functions increases the risk of conflicts.

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 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 third parties 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?

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.
(7) Communications 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.

Segregation of functions in valuation – Governance Standards and Guidance [5]

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to put in place valuation arrangements aimed at addressing and mitigating conflicts of interest in relation to asset valuation.**

  HFSB believes that the most satisfactory way to achieve this is for a hedge fund manager to do what it reasonably can to enable the fund governing body to appoint an independent and competent third party valuation service provider.

  HFSB acknowledges, however, that in some cases it will not be possible in practice to achieve both independence and the required level of competence by appointing a third party valuation service provider, in which case the involvement of the hedge fund manager in the asset valuation process will, to a greater or lesser extent, be unavoidable.

- **Where a hedge fund manager determines the value of any of the fund's assets (whether by performing valuations in-house or providing final prices to a valuation service provider), it should operate a valuation function which is segregated from the portfolio management function and should explain its approach to investors. If a smaller or start-up manager considers it impractical to do so, it should disclose this in its marketing documents and do what it reasonably can to enable and encourage the fund governing body to disclose this in the fund's offering documents.**

  It is envisaged that this will, amongst other things, entail:

  – ensuring that the relevant employees operate independently of the portfolio management team and that potential conflicts of interest are minimised;
  – ensuring that the remuneration of the valuation team is not directly linked to fund performance;
  – in instances where the portfolio management team has necessary expertise and understanding, ensure that information provided by that team in connection with the valuation process is properly documented and recorded; and
  – assisting fund governing bodies to satisfy themselves regularly that in-house valuations are handled appropriately.

  Ways to achieve this might include:
  – ensuring that valuation staff provide a report on the valuation process periodically to the fund governing body;
  – doing what it reasonably can to encourage the fund governing body to form a designated “valuation committee” (no member of which is involved in

investment decisions); and
- employing the services of an appropriate 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).

Hedge fund managers should refer to AIMA's Guide to Sound Practices for Hedge Fund Valuation (03/2007)[17] *and IOSCO's Principles for the Valuation of Hedge Fund Portfolios (11/2007)*[18] *for further guidance in this area.*

Segregation of functions in valuation – Disclosure Standards and Guidance [6]

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to prepare and adopt a document (a "Valuation Policy Document") covering all material aspects of the valuation process and valuation procedures and controls in respect of the fund. The Valuation Policy Document (which it is acknowledged will contain information which is proprietary to the hedge fund manager) should be reviewed regularly by the hedge fund manager, in consultation with the fund governing body, and be made available to investors upon request on a confidential basis.**

  HFSB envisages that in most circumstances the Valuation Policy Document will describe:
  - the responsibilities of each of the parties involved in the valuation process;
  - the processes and procedures in place that are designed to ensure conflicts of interest are managed effectively;
  - the relevant material provisions of any service level agreements (SLAs) entered into with third parties responsible for or involved in the valuation process (excluding details of commercial aspects of any such SLAs); and
  - the controls and monitoring processes in place that are designed to ensure that the performance of any third party to whom the valuation function is outsourced is satisfactory.

- **Where a hedge fund manager is involved in the valuation process, it should disclose in its own marketing materials, and/or do what it reasonably can to enable and encourage the fund governing body to disclose in the fund's offering documents, any actual or likely material involvement of the portfolio management team in the valuation process. Investors should then be informed, for example via manager newsletters, of any material changes to such level of involvement.**

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[17] http://www.aima.org

[18] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD253.pdf

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.

Hard-to-value assets – Governance [7]+[8]

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 hard-to-value assets.

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 box on pricing models on page 18) since market prices are not readily available.[19]

In addition, some hedge funds invest in hard-to-value 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 may 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"[20] for all assets. Given that hard-to-value 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 hard-to-value assets should be properly managed.

The HFWG identified the following issues in relation to the valuation of hard-to-value assets:

- Do hedge fund managers adequately manage challenges arising in valuing hard-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-pockets

As noted above, where a hedge fund invests in hard-to-value 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

[19] It is important to bear in mind that the valuation of exchange traded positions can also be uncertain, particularly if a position is 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.

[20] 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 (03/2007), Appendix 4.

hard-to-value assets.

On the one hand, if the hard-to-value asset is accounted for at cost[21], 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 hard-to-value assets while held, this would not guarantee fair treatment of investors since the realised value may still differ significantly from the estimates.

One common approach designed to overcome this is to place hard-to-value assets 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 hard-to-value investments and allow fair treatment of investors.

Pricing models

Hedge fund managers use pricing models to estimate the current fair value of many hard-to-value assets which are not continuously traded and for which no current market price is available. Banks and other financial institutions commonly use such models, particularly for valuing derivative positions. 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 drive prices in the future. The reliability of the model therefore 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 monitoring and managing pricing models, including handling of overrides to model inputs or results (see Standards and Guidance below).

[21] May be subject to regional accounting standards.

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.

Hard-to-value assets – Governance Standards and Guidance [7]

- **Where a hedge fund manager performs valuations of what it considers to be hard-to-value assets in-house or is otherwise involved in providing final prices to the valuation service provider, it should do what it reasonably can to enable and encourage the fund governing body to adopt valuation procedures for such assets which are aimed at ensuring a consistent approach to determining fair value and ensure that such procedures are set out in the Valuation Policy Document.**

  HFSB envisages that such procedures would in most circumstances include:

- details of a hierarchy of pricing sources and models to be used for each asset type in a fund's portfolio (where relevant);

- if using broker quotes:
  - making reasonable efforts to identify and draw upon multiple (typically 2-3) price sources (where available);
  - specifying the acceptable tolerance ranges when multiple pricing sources are used and the approach to handling "outliers";
  - ensuring consistency and avoiding "cherry picking" of favourable price sources by using the same brokers at each valuation point; and
  - where the hedge fund manager arranges the provision of broker prices (as opposed to the administrator or other third party valuation service provider), the hedge fund manager should instruct brokers to send the prices directly to the administrator (or other third party valuation service provider);

- if using pricing models, the hedge fund manager doing what it reasonably can to enable the fund governing body to have a process specified in the Valuation Policy Document for:
  - approving pricing models including back-testing, documentation and approval by the fund governing body or its valuation committee;

- monitoring and verification against observed market prices; and
- governing manual overrides of the model inputs or results, including approval, documentation and reporting to the fund governing body or its valuation committee.

▪ **If using side pockets, a hedge fund manager should ensure that the fund governing body has been consulted on, and consented to, the circumstances in which side-pockets may be used and should do what it reasonably can to enable and encourage the fund governing body to:**
  - **describe the types of asset eligible for side pocketing in the Valuation Policy Document and disclose the same and the side pocketing process in the fund's offering documents;**
  - **ensure that side-pocketing occurs either on or about the time the relevant asset is purchased or on or about the point at which, in the manager's view, the relevant asset becomes hard-to-value and that the initial valuation of an asset on entering a side-pocket is at cost[22], the last available market price (as appropriate) or a lower number or nil;**
  - **ensure that where a limit to the total amount of assets which may be included in side-pockets is disclosed in the fund's offering documents, such limit it not breached;**
  - **ensure that management fees, if charged, for the side pocketed assets are calculated on no more than the lower of cost (or last available market price in the case of a previously liquid asset) or fair value; and**
  - **ensure that any performance fees accrue for the duration of the existence of the side pocket and are paid only at the point at which the asset is finally disposed of or a liquid market price is available.**

Hedge Fund Managers should refer to AIMA's Guide to Sound Practices for Hedge Fund Valuation (03/2007)[23] and IOSCO's Principles for the Valuation of Hedge Fund Portfolios (11/2007)[24] for further guidance on the valuation of hard-to-value assets.

[22] May be subject to regional accounting standards.

[23] http://www.aima.org

[24] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD253.pdf

Hard-to-value assets – Disclosure Standards and Guidance [8]

- **A hedge fund manager should periodically disclose the percentage of the fund's portfolio that is invested in what the manager considers to be hard-to-value assets (e.g. via newsletters) and, where meaningful and applicable, the extent to which internal pricing models or assumptions are used to value certain components of the fund's portfolio invested in hard-to-value assets.**

  To enhance clarity and consistency of disclosure, hedge fund managers may wish to classify assets by the valuation methodology used (e.g. by adopting the fair value hierarchy used in FAS 157[25]).

- **Notification of any material increase (as determined by the fund governing body) in the percentage of a fund's portfolio invested in what the manager considers to be hard-to-value assets should be disclosed to investors in a timely manner, e.g. via the manager's newsletters.**

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to ensure periodic reporting of the value of side pockets in the fund's audited annual accounts in accordance with applicable accounting standards.**

- **A hedge fund manager conducting valuations in-house should discuss with the fund governing body any material issues in relation to the valuation of what the manager considers to be hard-to-value assets (e.g. unavailability of a sufficient number of pricing sources or dispersion of broker quotes beyond tolerance levels) and, if the fund governing body considers it appropriate, do what it reasonably can to enable and encourage the fund governing body to disclose the same to investors.**

[25] http://www.fasb.org/pdf/fas157.pdf, p. 22.

C. Risk Management [9]-[20]

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 HFSB'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 (Standards [9]-[10])
- Standards covering management of:
  Portfolio risk (Standards [11]-[16])
  Operational risk (Standards [17]-[18])
  Outsourcing risk (Standards [19]-[20]).

Risk Framework

Given the complexity and breadth of risk issues, managers 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 HFWG identified the following issue on managing risk:

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

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.

Risk framework - Governance Standards and Guidance[26] [9]+[10]

- **A hedge fund manager should put in place a risk framework which sets out the governance structure for its risk management activities and specifies the respective reporting lines, responsibilities and control mechanisms intended to ensure that risks remain within the the manager's risk tolerance as conveyed to and discussed with the fund governing body.**

  Risk tolerance is sometimes also referred to as risk appetite and describes the willingness of an organisation to assume risks. Management of the relevant organisation has to decide how much risk it is willing to take in each area of risk and then take action to manage or mitigate these risks accordingly. Therefore, for the risk manager, appetite refers to portfolio, operational and outsourcing risk.

- **The framework should cover all relevant categories of risk including portfolio, operational and outsourcing risks.**

[26] 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 .

Risk framework - Disclosure Standards and Guidance [10]

- **A hedge fund manager should explain its approach to managing risk (its risk framework) to the fund governing body and do what it reasonably can to enable and encourage the fund governing body to explain, to the appropriate extent, such risk framework in the fund's offering documents.**

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

Risk category overview

Category	Description	Risk for whom	Covered in Standards
Portfolio risks	Risk of losses in the investment portfolio	Direct risk for investors, indirect (reputational) risk for the manager	[11]-[16]
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	[17]-[18]
Outsourcing risks	Risk of failures in the delivery of services by third parties	Direct risk for the manager, indirect risk for investors	[19]-[20]

Portfolio Risk [11]-[16]

The HFWG identified the following issue on portfolio risk:

- Do hedge fund managers adequately monitor portfolio risks to ensure alignment with stated risk appetite?
- Is the risk appetite of hedge funds adequately disclosed in managers' marketing materials and/or funds' offering documents 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 guidance relating to the following areas of portfolio risk management:

- **Governance (Standard [11])**: adequate governance of the risk function to ensure that potential conflicts of interest between the hedge fund manager and the investor are properly mitigated.
- **Measurement (Standards [12], [13], [14])**: adequate measurement of the different sources of portfolio risk.
- **Control (Standard [15])**: monitoring processes to ensure the portfolio remains within the boundaries set.
- **Investor disclosure (Standard [16])**: assuring investors that risk management processes are in place.

Others have also developed high quality materials on portfolio risk management, including AIMA[27], MFA[28] and the Risk Standards Working Group.[29] The HFWG recommends these documents as further guidance for hedge fund managers in developing and enhancing their approach to portfolio risk management.

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

[28] Managed Fund Association: MFA's 2007 Sound Practices for Hedge Fund Managers, http://www.managedfunds.org

[29] Risk Standards Working Group: Risk Standards for Institutional Investment Managers and Institutional Investors, http://www.cmra.com/risk.pdf

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) Communications 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.

Portfolio risk - Governance Standards and Guidance[30] [11]

- **A hedge fund manager should ensure that adequate risk management processes 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. A hedge fund manager should also discuss these risk management processes with the fund governing body and do what it reasonably can to assist the members of the fund governing body to understand such processes.**

- **Potential conflicts of interests in the risk monitoring process should be managed by clearly separating the risk monitoring function from portfolio management. If a smaller or start-up manager considers it impractical to do so, it should disclose this in its marketing documents and do what it reasonably can to enable and encourage the fund governing body to disclose this in the fund's offering documents.**

  HFSB recognises that notwithstanding the separation of the risk monitoring and portfolio management functions, portfolio managers will typically provide input into the risk parameters to be applied to the portfolio (e.g. types of trades, degree of risk and areas of risk).

[30] Further guidance can be found in AIMA's Guide to Sound Practice for European Hedge Fund Managers, 2007, 2.1.2.

- **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).**

- **A hedge fund manager should put in place a written Risk Policy Document, a copy of which should be supplied to the fund governing body. This document should set out the responsibilities of and procedures to be employed by the hedge fund manager's risk monitoring function.**

  HFSB expects that in most circumstances the Risk Policy Document might, amongst other things, 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; and
  - routines for communicating the above information to all relevant persons within the hedge fund manager in a clear and understandable manner.

Portfolio risk - 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.

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 of best practice standards for measuring **liquidity**, **market** and **counterparty** risk.

Liquidity risk management

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. 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 leveraged[31] nature of many hedge funds may make their cash position more sensitive to sudden market distress than that of long-only 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 vigilant in measuring and managing liquidity risks.

Liquidity risk management - Standards and Guidance [12]

- **A hedge fund manager should develop a liquidity management framework, the primary role of which is to limit the risk that the liquidity profile of the fund's investments does not align with the fund's obligations.**
  This could include forecasting the liquidity position of the fund and tracking liquidity measures (e.g. ratios such as "available cash/Value-at-Risk") which allow the hedge fund manager to assess the probable development of the fund's liquidity position relative to the portfolio's inherent risk.

  The nature of this framework would depend on the categories of assets and leverage profile of the hedge fund.

- **A hedge fund manager should regularly 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 (e.g. significant equity price falls);
  – reduction in liquidity in certain market segments relevant to the fund;
  – a 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) (where relevant[32]); and
  – cancellation of credit lines (as per notice periods agreed between the fund and counterparties such as prime brokers).

  The stress testing/scenario analysis should also take account of the impact of market risk stresses on the liquidity position of the fund (see following market risk management standard).

  It has been widely found that in stress situations unexpected correlations 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.

[31] Further guidance can be found in AIMA's Guide to Sound Practice for European Hedge Fund Managers, 2007, 2.1.2.

[32] Will only be relevant for open-ended hedge funds.

Market risk management

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 risk[33] and correlation risk[34].

Market risk management - Standards and Guidance [13]

- **A hedge fund manager should develop measures to identify market risk in the fund's portfolio. To overcome the shortcomings of individual measures, the hedge fund manager should rely on multiple techniques.**

  These could include, amongst others:
  - volatility measures;
  - VaR type approaches;
  - Monte Carlo simulation[35];
  - stress tests/scenario analyses[36];
  - impact of leverage; and
  - portfolio concentration measures.

- **A hedge fund manager should conduct regular stress testing/scenario analysis to assess the impact of extreme market occurrences on the value of the portfolio.**

  Extreme financial events may not receive sufficient attention when using classic risk measures such as volatility and VaR 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.[37]

  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.

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

[34] Correlation risk: the risk of change in the (expected) correlation between asset prices.

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

[36] 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).

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

The analysis could include, among other things, scenarios based on historically observed crises (e.g. 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 strategies[38] and incorporate resultant uncertainties into their stress testing/scenario analysis approach.

- **A hedge fund manager should account for valuation sensitivities under stressed conditions in its approach to risk measurement (e.g. VaR, stress testing/scenario analysis).**

  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 also 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, for example by applying valuation discounts for modeling purposes to positions that might have to be liquidated under stressed conditions (see Standard [12] *(Liquidity risk management)*).

- **A hedge fund manager should translate the results of the analysis of market risks (stress tests/scenario analysis, etc) into timely management action (e.g. adjustment of positions) as part of the control and risk management process.**

Limitations of individual risk measures

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.[39]

[38] 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.

[39] E.g., during the month of July 2007 the ABX AAA 07-01 index dropped in price from 99.5 to 88.

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 over-rated derivatives) and volatility of liquidity premiums.

Counterparty credit risk management

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 following best practice will implement a spectrum of measures to monitor and contain counterparty credit risks to acceptable levels.[40]

Counterparty credit risk management - Standards and Guidance [14]

- **A hedge fund manager should have a process for setting up trading relationships on behalf of the fund, including the assessment of creditworthiness and the setting of risk limits.**

  In setting up such trading relationships, a hedge fund manager may, where relevant and appropriate, wish to consider putting netting agreements and appropriate collateral arrangements in place. For example, it may be possible for certain funds to agree two-way collateral posting with a trading counterparty.

- **Creditworthiness of the fund's trading counterparties should be monitored periodically and risk limits adjusted if required**

[40] 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.crmpolicygroup.org See also MFA's 2005 Sound Practices for Hedge Fund Managers (4.9).

Control processes

There is little point in having sophisticated risk measurement methodologies unless the results are translated into management action.

Control processes - Standards and Guidance [15]

- **A hedge fund manager should track a fund's adherence to its stated investment objectives, investment policy/strategy and investment and other restrictions and take appropriate corrective action if a breach of investment policy/strategy or of any restrictions or limits occurs.**

  To assist in tracking a fund's adherence to its stated investment objectives, investment policy/strategy and investment and other restrictions, hedge fund managers should carefully consider setting internal limits and sub-limits at the outset for the aggregate portfolio and, where applicable, to all individual sub- portfolios (each of which would be subject to override by the hedge fund manager's chief executive officer, chief investment officer, management committee or similar). These limits could include general investment restrictions (e.g. eligible asset classes, geographic location of risk) and could also encompass various categories of risk such as market risk, funding liquidity risk, counterparty credit risk and other relevant risk factors such as concentrations (e.g. in relation to single names, sectors or hard-to-value assets).

  Risk reporting should be put in place so that the investment decision-makers have a daily (or more frequent if appropriate) view of the risk position of the fund and are in a position to prevent breaches of any relevant limits and restrictions. Breaches of any relevant limits or restrictions should be immediately reported to the relevant fund manager, the manager of the trading activity and the compliance officer, with escalation as needed to the manager's chief executive officer, chief investment officer, management committee or similar. A process for determining when and how breaches should be reported to the fund governing body should be put in place (a manager will want to ensure that such process takes into account insurance related considerations).

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

Portfolio risk - Disclosure Standards and Guidance [16]

- **A hedge fund manager should disclose and explain its investment and risk management approach in its own marketing materials and do what it reasonably can to enable and encourage the fund governing body also to include, to the appropriate extent, such disclosure and explanation in the fund's offering documents. In addition to disclosure recommended in Standard [1] (*Investment policy and risk disclosure*), a summary of the risk framework**

(processes and risk management techniques employed) should be disclosed.

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 and how short-term deviations from such target ranges are handled, and advise the fund governing body accordingly. This could include:

- volatility of returns;
- VaR or equivalent (e.g. potential loss arising from a stress event);
- leverage (according to the manner in which the manager measures leverage)[41]; and
- limits to the percentage of the portfolio which can be invested in non-marketable securities[42] (or another measure of liquidity).

- **A hedge fund manager should ensure that the management report submitted with the audited annual accounts of the hedge fund includes disclosures on the actual risk profile of the fund for the relevant period.**

HFSB envisages that this might include:

- the actual risk profile of the fund**,** where applicable using risk measures such as
  - realised volatility of returns;
  - VaR type measures (actual, average, range for observation period and decomposed by, for example, risk type and market); and
  - leverage (high, low, average for the respective observation period), if applicable;
- the percentage of the portfolio invested in what the manager considers to be hard-to-value assets (see more detailed disclosure requirements for hard-to-value assets in the Standards relating to valuation); and
- investment instruments used during the relevant period.

Hedge fund managers should carefully consider whether providing more frequent (e.g. quarterly) disclosure of relevant performance and risk measures to investors through a suitable medium (e.g. newsletters) would be appropriate.[43]

HFSB acknowledges that investors may require more frequent disclosures via newsletters than the annual disclosures set out above. However, the frequency,

[41] See Appendix E for examples of leverage measures.

[42] 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 recognised public exchanges.

[43] Further guidance on risk measures is provided by the "Investor Risk Committee Report – Hedge Fund Disclosure for Institutional Investors", Section 1, issued by the International Association of Financial Engineers, http://www.iafe.org/upload/IRCConsensusDocumentJuly272001.pdf

required content and granularity of such disclosures will be a function of the fund's strategy. For example, high turnover strategies may require more frequent disclosure than private or distressed debt strategies. Risk measures used may also differ substantially between funds. Therefore, HFSB has not sought to be prescriptive in this area.

Operational Risk [17]+[18]

Managing and mitigating operational risk 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 HFSB considers compliance with best practices to be particularly important:[44]

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

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) Communications 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.

[44] 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, AIMA and MFA and are highlighted below.

People and Governance

Operational risk - Governance Standards and Guidance [17a]

- **In areas where potential conflicts of interest could arise (valuation, risk management, compliance), a hedge fund manager should clearly divide these activities from the portfolio management function with separate reporting lines into the manager's chief executive officer or chief investment officer or similar. If a smaller or start-up manager considers it impractical to do so, it should disclose this in its marketing documents and do what it reasonably can to enable the fund governing body to disclose this in the fund's offering documents.**

- **A hedge fund manager's staff remuneration should not set false incentives (e.g. by linking the compensation of the valuation team directly to fund performance).**

- **A 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 other things, areas such as compliance procedures, back-up/disaster recovery procedures, personal account dealing policies and client confidentiality. A hedge fund manager should also periodically test its compliance procedures or have them audited by an external party.**

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.[45]

Operational risk – trading and execution Standards and Guidance [17b]

- **To prevent trading and execution failures, a hedge fund manager should put effective trading and counterparty procedures in place.**

  This might include the following aspects:
  - entering into master agreements with trading counterparties;
  - agreeing well defined termination and collateral policies;
  - tracking changes in key provisions of any agreements with trading counterparties; and
  - a robust trade confirmation and reconciliation process including, amongst other things:

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[45] 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).

- sufficient back- and middle-office capacity to handle trading volumes;
- daily confirmation of trades and positions;
- use of electronic matching and confirmation systems (depending on the scale of the manager - smaller managers and managers with low trading volumes may rely to a larger extent on manual handling);
- timely reconciliation of complex over-the-counter trades and loans; and
- monitoring of corporate action events (e.g. voting, splits, spin-offs) on long and short equity derivative instruments and applying the events to fund accounts.

Documentation issues

There are numerous illustrations where the interplay of legal and documentation risks surface between hedge funds and the dealer, investor and regulatory community. Indeed, the origins of much of the credit and counterparty and investor risks in the market lie in the 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 counterparts involving credit derivative transactions. The NY Federal Reserve, assisted by the FSA, intervened and, with the major dealers, identified the key triggers and drivers. 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 dealers and hedge funds globally, vastly reducing the number of undocumented and unsigned assignments within a short time. This set of private sector initiatives reversed years of increased operational and legal risks and restored much needed stability to the market.

There is a series of issues relating to legal risk where documentation is very important. Hedge funds and their dealer and investor colleagues interact with one another on a series of topics including:

- enforceability of master netting agreements across legal jurisdictions;
- trigger mechanisms as to what determines a default action in a master agreement based upon insufficient NAV; and
- 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.

Fraud and financial crime prevention

Financial crime and fraud pose a serious threat to individual managers and can undermine the integrity of the financial services sector and markets as a whole.[46]

Operational risk – fraud and financial crime prevention Standards and Guidance [17c]

- **A hedge fund manager should be confident that it understands the applicable laws and regulations in the markets in which it deals and has effective systems and controls in place to enable it to identify, assess, monitor and manage the risk that it is used to further financial crimes.**

  This may apply to areas such as:
  – anti-money laundering procedures[47] (although typically the fund's administrator will be responsible for compliance);
  – procedures to prevent market abuse offences (see also Standard [23] *(Prevention of market abuse))*; and
  – strict internal controls to prevent misappropriation of client money (e.g. co-signing policies), where client money is held by the manager.

- **A hedge fund manager should appoint a compliance officer who is independent of the portfolio management function to oversee all issues relating to regulatory compliance and market and professional conduct. If a smaller or start-up manager considers it impractical to do so, it should disclose this in its marketing documents and do what it reasonably can to enable the fund governing body to disclose this in the fund's offering documents. The compliance officer should report regularly to the manager's chief executive officer or management committee or equivalent. A hedge fund manager should provide to the fund governing body a report on regulatory compliance prepared by the compliance officer on a regular basis.**

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.[48]

[46] Further references: FSA handbook (e.g. 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

[47] 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).

Operational risk – disaster recovery Standards and Guidance [17d]

- **A hedge fund manager should put in place measures designed to ensure that the provision of fund management services to the fund 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 and, where relevant, be notified to the fund governing body.**

  Depending on the scale of the hedge fund manager's business, this could include:
  - a communication plan to contact important parties (such as senior management, prime broker, administrator and regulator);
  - contingency plans (including a succession plan to address key man risk, fall back communications router and capabilities);
  - offsite data back-up facilities;
  - back-up office space/infrastructure (applicable to larger hedge fund managers); and
  - regular testing of procedures/processes.

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; and
- 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 use human judgment 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.

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[48] 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).

Operational risk – model risk Standards and Guidance [17e]

- **As part of its operational risk management procedures, a hedge fund manager should assess any exposure to model risk annually or as dictated by events 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 might 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 but such overrides need to be governed carefully);
  – documentation of models to avoid key man risk; and
  – security of algorithm and source code (back-up).

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.[49]

Operational risk – IT security Standards and Guidance [17f]

- **A hedge fund manager should ensure security and integrity of systems and data.** Depending on the scale of the manager, this could include system testing, offsite IT and data back-up, disaster recovery procedures and supervision of contract IT resources.

Legal and regulatory risk

Hedge fund managers often trade in securities in multiple jurisdictions and therefore need to understand applicable local rules and regulation.

Operational risk – legal and regulatory risk Standards and Guidance [17g]

- **A hedge fund manager should ensure that it understands local conduct of business rules and regulations which apply in the jurisdictions in which it operates (including any rules governing the passporting of regulatory authorisations from one jurisdiction to another). A hedge fund manager should**

[49] Further guidance on sound practices on IT security can be found in AIMA's Guide to Sound Practices 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).

also ensure that it understands laws and regulations relevant to the securities in which it trades (e.g. shareholding disclosure requirements and foreign ownership rules).

Operational risk - Disclosure Standards and Guidance [18]

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

Outsourcing risk [19]+[20]

The hedge fund industry is traditionally based on a strongly unbundled business model, with managers focusing 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; and
- 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 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 recommending third party service providers for the fund?
- Are third party service providers adequately monitored?
- Do hedge fund managers themselves provide or, where appropriate, encourage the provision by other service providers of 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?

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.

Outsourcing risk - Governance Standards and Guidance [19]

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

- **A hedge fund manager should ensure that careful due diligence on third party service providers is conducted before recommending them to the fund governing body.**

  This could include using Due Diligence Questionnaires or evaluating "reports on controls" from an independent reporting accountant issued by the respective third party service provider.[50]

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to properly and regularly review third party service providers.**

Valuation and administration

- **A hedge fund manager should, where appropriate, do what it reasonably can to enable and encourage the fund to put a service level agreement ("SLA") in place with relevant service providers (commonly, this will be attached as a schedule to the agreement between the fund and the relevant service provider).**

  A SLA would normally be expected to:
  - set out in precise detail the services to be provided by the relevant service provider along with deadlines for completion of the services;
  - make clear accountability and responsibility for the orderly operation of all administration or other functions performed by the relevant service provider on behalf of investors; and
  - include "Key Performance Indicators" 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 relevant service provider.

  Further examples of the contents of SLAs are provided in Appendix J.

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to review the services provided by the relevant service provider against contractual or other agreed standards.**

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[50] Reports on controls under the (US) SAS70, (UK) AAF 01/06 or other standards include a report from an independent reporting accountant.

Prime brokers

- **A hedge fund manager of a large hedge fund should carefully consider whether it is appropriate for the hedge fund to appoint more than one prime broker (taking into account in particular the potential advantages of diversification of funding and other services) and do what it reasonably can to enable and encourage the fund governing body to act accordingly.**

  HFSB is aware that there is a spectrum of criteria to consider when choosing a prime broker, including efficiency and operational risk considerations.

  In carrying out due diligence on a prime broker, a hedge fund manager should consider the potential prime broker's credit rating, policy on rehypothecation and general ability to fulfill all process functions accurately and efficiently.

Auditors

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to appoint reputable auditors.**

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

Outsourcing risk - Disclosure Standards and Guidance [20]

- **A hedge fund manager should disclose the names of its principal third party service providers in its due diligence documents or upon request.**
- **A hedge fund manager should, to the extent it is able or permitted to do so, provide information on the fund's committed funding or financing arrangements with prime brokers/lenders to investors in its due diligence documents or upon request.**
- **A hedge fund manager should disclose the nature of any special commercial terms with its third party service providers which result in potential conflicts of interest (e.g. in-house brokerage or rebates).**
- **A hedge fund manager to the extent applicable should disclose the monitoring procedures in relation to its third party service providers in its due diligence documents or upon request.**

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

D. Fund Governance [21]+[22]

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 may not have been accorded great importance when the hedge fund industry was in its infancy, perhaps reflecting 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. As such, these relationships were essentially based on mutual knowledge and trust at that time. 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, HFSB 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; and
- 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 and their friends, families and other contacts 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 even in these circumstances at times of stress the nature of the relationship between the manager, the fund governing body and the investors 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 depersonalisation, institutionalisation and “retailisation” of the investor base by the fund manager seeking to strengthen the fund governing body and giving more prominence to the distinction and independence between the fund governing body and the hedge fund manager. Such independence may be reflected in the composition of the fund governing body and/or the ability of the fund governing body to terminate the investment management agreement.
- In the case of listed or quoted closed-ended vehicles, this is likely to make compliance with all or substantially all of the provisions of established codes of corporate governance and other director guidance desirable (or perhaps versions of such codes or guidance 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.

Of course, HFSB 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 identified in relation to the establishment of appropriate fund governance mechanisms was therefore:

- Do hedge fund managers provide a satisfactory mechanism or vehicle for handling potential conflicts of interest between themselves and investors?

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) Communications 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.

Fund governance Standards and Guidance [21]

- **Prior to the establishment of a fund, a hedge fund manager 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 seeking to ensure that a fund governance structure which is suitable and robust to oversee and handle potential conflicts of interest is put in place at the outset.**

- **A hedge fund manager should on the establishment of a fund do what it reasonably can to encourage and assist the fund governing body to identify and recruit members of the fund governing body 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.**

- **A hedge fund manager should throughout the life of the fund be cognisant of the need for the fund governing body and governance processes to be effective and**

appropriate (having regard, among other things, to any changes in the nature of the fund and its investors), advise the fund governing body accordingly and do what it reasonably can to encourage and assist the fund governing body to make any changes which in the light of such advice the fund governing body considers to be necessary or desirable (including recommending suitable individuals it has identified as additional or replacement directors as appropriate).

- **A hedge fund manager should encourage and assist the fund governing body to meet regularly, to conduct such meetings in a manner which safeguards the intended legal, regulatory and tax status of the fund and to document such meetings properly.**

  – In normal circumstances HFSB would expect fund governing bodies to meet at least quarterly.

- **A hedge fund manager should carefully consider the extent to which the adoption by the fund governing body of all or parts of established codes of corporate governance or other director guidance[51] is appropriate and do what it reasonably can to encourage and assist the fund governing body to act accordingly. This includes ensuring that the fund governing body has adequate resources to comply with any such corporate governance code or director guidance.**

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

  As guidance to managers when considering which corporate governance code or director guidance are appropriate for fund governing bodies to adopt, HFSB has set out below a selection of those principles contained in the corporate governance codes and director guidance published by AIC and AIMA which it considers to be of greatest importance[51]. HFSB 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 fund's offering documents) and the board as a whole (at the first available meeting) (AIMA 1.4);

  – fund boards should have sufficient collective expertise, availability and be otherwise qualified to understand the investment policy and strategies of the fund

[51] 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 (2008) www.aima.org (the full text is only available in nard copy).

and the attendant risks (AIC 6, AIMA 1.4). Expertise should include areas such as investment management, regulatory issues, accounting, administration and technical understanding of the fund’s strategies;

– the board should put in place a policy on tenure of directors and disclose it in the fund’s offering documents 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 1.6). Typical board agendas may 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), review of the manager’s risk management procedures;
– there should be regular review of adherence by 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 3.5 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) (e.g. AIMA 4.2 and 6.2 and 6.5);
– the fund directors should be made aware of their personal responsibility for the issuance and legality of side letters or discretionary waivers (AIMA 6.9 and 6.11); and
– the directors should consider whether the fund should take out D&O insurance proportional to any liabilities relating to the directors’ role with respect to the fund (AIMA 7).

▪ **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to obtain from the fund's administrator regular reports on compliance with laws and regulations (in particular those relating to anti-money laundering) applicable to activities which are performed by the administrator on behalf of the fund.**

Fund Governance – Disclosure Standards and Guidance [22]

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to disclose details of the fund governance structure which is put in place in the fund's offering documents.**

  This could include elements such as:
  - biographies of each director setting out details of his/her experience relevant to performing the role of a member of the fund governing body;
  - an indication as to whether each member of the fund governing body is independent of the hedge fund manager; and
  - details of any corporate governance code or director guidance with which the fund governing body has agreed to comply.

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to disclose 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 any aspect of decision-making in respect of the fund in the fund's offering documents.**

  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.

E. Shareholder conduct, including activism [23]-[28]

Investors who take on a more pronounced role in dealing with companies in which they are invested with a view to encouraging behaviour more beneficial to shareholders 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 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 labeled 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 governance[52]. 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 here 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 in relation to their conduct on behalf of funds which are shareholders in investee companies. Relevant areas include prevention of market abuse, such as insider trading, and other issues relating to shareholder conduct.

It is important to note that the best practice approaches identified in the following sections might well merit consideration for adoption by all investors as well as applying to hedge funds.

The subsequent standards apply to all hedge fund managers, whether activist or not.

Prevention of Market abuse [23]+[24]

Proper market conduct and prevention of market abuse are crucial to maintaining market integrity and overall confidence in financial markets. Of course, market abuse applies to a much wider range of activities than just activism. 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"). In addition to the five market abuse offences introduced by MAD,

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[52] E.g. see OECD Report on ”The Implications of Alternative Investment Vehicles For Corporate Governance”, July 2007, http://www.oecd.org/dataoecd/60/11/39007051.pdf

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.

However, 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 to ensure compliance with applicable market abuse laws and regulation.

The HFWG identified the following issue in relation to market abuse:

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

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.

Prevention of market abuse – Governance Standards and Guidance [23]

- **A hedge fund manager should ensure that it has internal compliance arrangements which are designed to identify, detect and prevent breaches of market abuse laws and regulations.**

  A sound approach might include the following components:
  - a dedicated compliance officer who is not involved in the investment management process;
  - a written compliance document describing all relevant compliance procedures;
  - documentation of all compliance incidents by the compliance officer in accordance with, where relevant, applicable regulatory requirements;
  - 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;
  - the provision of regular compliance reports to the fund governing body;
  - seeking legal and regulatory guidance to ensure that compliance arrangements are designed to prevent regulatory breaches; and

– open relations with its regulator.

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

Examples of compliance procedures designed to identify, detect and prevent market abuse

Abuse	Procedures
Insider dealing	▪ 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 should 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 (e.g. restricted in the order management system). ▪ Where practicable, use of 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 inside information	▪ 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 (e.g. by advocating/suggesting a corporate restructuring).
Non-disclosure of shareholdings when disclosure thresholds have been exceeded	▪ Managers should document arrangements with other parties (e.g. other managers) together with which it has adopted a "lasting common policy towards the management of the issuer in question". ▪ Relevant disclosures should take place if disclosure thresholds are exceeded, accounting for collective share ownership of all parties involved.
Prevention of market manipulation	▪ Public relations policies regarding public statements of intent to seek to ensure that no false or misleading impressions are given to the market.

Prevention of market abuse – Disclosure Standards and Guidance [24]

- **A hedge fund manager should disclose to investors in its own marketing materials that it 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 publications[53]. The HFWG recognises the complexity of the issues and would welcome further guidance from regulators, as well as being ready to participate in necessary debate.

Examples of potential 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.

Proxy voting [25]+[26]

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, where possible, in corporate decisions that affect the performance of investments.

The HFWG identified the following issue in relation to proxy voting:
- Do managers fulfill their duty to vote proxies where it is in the best interest of investors?

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.

[53] 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

Proxy voting – Governance Standards and Guidance [25]

- **A hedge fund manager should have a proxy voting policy which allows investors to evaluate the general approach the manager takes towards proxy voting. A summary thereof should be made available to investee companies on request.**

  HFSB envisages that a voting policy might 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;
  – a process for deciding when and how to communicate with an investee company's management or board of directors and other shareholders; and
  – a process for determining whether to join the efforts of other concerned investors, with due regard to compliance procedures to prevent market abuse (see Guidance in Standard [24] *(Prevention of market abuse)*).

  It is acknowledged that prime brokers will often not undertake to notify funds or their managers of corporate events. The proxy voting policy may well state, therefore, that the manager's ability to follow such policy will depend on its being aware of the opportunity to vote.

  HFSB acknowledges that it may not be part of a manager's strategy to vote all proxies (e.g., "black box" traders[54]) and a manager might, for cost benefit considerations, adopt a systematic approach, for example never voting except in exceptional circumstances, rather than evaluating each proxy situation. In such circumstances, this should be explained to investors in accordance with the comply or explain regime.

Proxy voting – Disclosure Standards and Guidance [26]

- **A hedge fund manager's proxy voting policy should be made available to investors upon request. A hedge fund manager should also document cases where the voting policy has not been followed and report accordingly to the fund governing body.**

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

Disclosure of derivative positions [27]

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/leverage[55]. 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 Rules[56]) as shares owned outright.[57]

The HFWG 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?

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.

Disclosure of derivative positions

HFSB 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 fund managers.

HFSB welcomes the FSA consultation[58] on the disclosure of contracts for difference and looks forward to its results.

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[55] 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.

[56] Disclosure and Transparency Rules, e.g. requiring disclosure of share ownership if certain thresholds are exceeded.

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

[58] FSA's Consultation paper 07/20 "Disclosure of contracts for difference" (November 2007): http://www.fsa.gov.uk/pubs/cp/cp07_20.pdf

Borrowing stock to vote [28]

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 in order to vote at shareholder meetings, 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 identified the following issue on borrowing stock:

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

Borrowing stock to vote – Governance Standards and Guidance [28]

- **A hedge fund manager should not borrow stock in order to vote.**

  HFSB acknowledges that there might be specific situations where it should be acceptable to vote on borrowed stock, e.g. when a fund is invested in shares (and the trade has settled), but the shares have not transferred into their name.

Acknowledgement of legal firms

The HFWG would like to thank Herbert Smith LLP for legal counsel and major help in drafting and refining the Standards. The HFWG would also like to acknowledge the valuable contribution to the refinement of the Standards made by Simmons & Simmons and Dechert LLP. The HFWG hopes that the work put into the Standards by these three firms will facilitate their widespread and early adoption by the hedge fund community.

Appendix A. Members of the Hedge Fund Working 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 Management, Disclosure, Valuation and Shareholder Conduct (including activism). Focus groups for each comprised.

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

Appendix B. FSA Principles

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

Appendix C. Signatory Pack

The signatory pack provides details of the process of signing up to the Standards. The pack comprises:

1. Explanatory Memorandum for Signatories
2. Application Form to Become a Signatory
3. Conformity Statement
4. Explanatory Memorandum of Hedge Fund Standards Board, its Interim Trustees and Trustees

All documents follow; please visit http://www.hfsb.org to print them.

1. **Explanatory memorandum for signatories**

EXPLANATORY MEMORANDUM FOR SIGNATORIES

Process for becoming a signatory

Managers wishing to become signatories to the Standards may apply to HFSB for an application form. The application form, which should be completed and delivered to HFSB, contains five undertakings together with certain acknowledgements. The undertakings required from the hedge fund managers are

- to adopt the "comply or explain" approach described in the Standards,
- to provide funding towards the working capital of HFSB,
- from the date on which they adopt the "comply or explain" approach, to communicate as appropriate in their marketing materials and/or to display on their website that they are a signatory to the Standards,
- from the date on which they adopt the "comply or explain" approach, to do what they reasonably can to ensure that this is communicated to investors and prospective investors in hedge funds managed or advised by them through the prospectuses or offering memoranda for such funds (either when such documents are first published or, in the case of existing documents, next updated),
- to produce three statements in relation to its conformity with the comply or explain regime, as further described below.

HFSB will consider all valid applications to become a signatory and will notify those accepted in writing formally as soon as practicable following receipt of a duly completed application form. Acceptance will be at the discretion of the Board of Trustees of HFSB. HFSB may request further information regarding the applicant before making its decision.

HFSB will notify managers wishing to become signatories of the funding requirement for the period to 31 March 2009 prior to completion and submission of their application form. This will be calculated on an equitable basis, with a smaller contribution expected from smaller managers, and will be notified to managers in advance.

Disclosure Statement

This is envisaged as a relatively brief document providing investors with overview details of those Standards, if any, with which the manager does not comply, either because they are unable to comply or choose not to do so. It may be that certain prospective investors will require a more detailed explanation of the degree to which the manager does not to comply. This requirement might be satisfied by a more detailed disclosure containing some or all of the information proposed to be included in the Explanatory Statement.

Explanatory Statement

The Explanatory Statement is envisaged to be a private document, updated from time to time as appropriate, in which the hedge fund manager would on request explain to HFSB, or such other person as it may nominate (for example AIMA), in detail the reasons why the manager does not comply with certain of the Standards, either because they are unable to comply or choose not to do so.

Conformity Statement

The final statement is a Conformity Statement which is intended to be a public declaration made as at 31 December in each year from 2008 onwards, provision of which to HFSB would entitle the hedge fund manager to continue to display the HFSB logo on its website and/or marketing materials.

Signatory status

As noted above a signatory undertakes to conform with the Standards and to provide funding for HFSB. The signatory's status is not that of a shareholder or member of HFSB, however. The members of HFSB will be its Board of Trustees but, as set out in the application form, all signatories will be invited to an annual meeting of HFSB at which they would have a vote on the appointment, re-election or removal of Trustees.

Eligibility to be a signatory

HFSB retains absolute discretion as to which firms may become signatories. HFSB will accept applications only from fund managers engaged in hedge fund management activity. HFSB will welcome applications from such fund managers based in the UK and from any such fund manager based outside the UK who considers that becoming a signatory would be of value to them.

In the event that a signatory fails to comply with the undertakings given by it in its application form, the Board of Trustees may, at their sole discretion, revoke their acceptance of that fund manager as a signatory. In the event that a fund manager ceases to be a signatory, it will not hold itself out in any way as a signatory and in particular will cease to communicate in its marketing materials and/or to display on its website that it is a signatory to the Standards.

Hedge Fund Standards Board

22 January 2008

No responsibility, duty of care or liability whatsoever (whether in contract or tort or otherwise including, but not limited to, negligence) is or will be accepted by HFSB or the Board of Trustees of HFSB to signatories, investors or any other person in connection with the Standards or any Conformity Statement made by any signatory.

HFSB and the Board of Trustees of HFSB do not accept any responsibility or liability for any loss or damage caused to any person who acts or refrains from

acting as a result of anything contained in or omitted from the Standards or any Conformity Statement made by any signatory or in reliance on the provisions of or material in the Standards or any Conformity Statement made by any signatory, whether such loss or damage is caused by negligence or otherwise.

2. **Application form to become a signatory**

APPLICATION TO BECOME A SIGNATORY TO THE HFSB BEST PRACTICE STANDARDS

To: Hedge Fund Standards Board Limited
13th Floor, The Adelphi
1/11 John Adam Street
London WC2N 6HT
Registered No. 6465317, England and Wales

Hedge Fund Standards Board Limited ("**HFSB**") has been formed to act as the trustee entity described in the HFWG Final Report issued on 22 January 2008 (the "**Standards**") and to fulfil the mandate described within those Standards.

We, the organisation described below, wish to become a signatory to the Standards**.**

As a result, upon acceptance of our application by HFSB, we undertake:

1. to adopt the "comply or explain" approach described in the Standards as soon as practicable but in any event by no later than 31 December 2008;
2. to provide funding towards the working capital of HFSB. We understand that this funding will be used in an interim phase to develop the formation and operation of HFSB and will be subject to modification over time;
3. from the date on which we adopt the "comply or explain" approach described in the Standards (and not before), to communicate as appropriate in our marketing materials and/or to display on our website that we are a signatory to the Standards and to do what we reasonably can to ensure that this is communicated to investors and prospective investors in hedge funds managed or advised by us through the prospectuses or offering memoranda for such funds (either when such documents are first published or, in the case of existing documents, next updated). We further understand that upon acceptance of our application you may include our name as a signatory to the Standards on your website and/or in materials which you may issue;
4. with effect from no later than 31 December 2008, to make available to investors and prospective investors in hedge funds managed or advised by us upon request a statement **("Disclosure Statement")** in relation to those Standards, if any, with which we do not comply either because we are unable to comply or choose not to do so; and
5. to provide to HFSB and/or such person(s) as it may nominate as at 31 December 2008 and annually thereafter a statement **("Conformity Statement")** in relation to the Standards within two weeks of the date to which such Conformity Statement is made and, as and when reasonably requested by HFSB, to provide to

HFSB and/or such person(s) as it may nominate a supplementary statement (**"Explanatory Statement")** which sets out particulars of those Standards with which we comply and explanations in relation to the remainder of the Standards, if any, with which we do not comply. Pending such provision, the Explanatory Statement will be maintained by us as an internal document, updated as appropriate, from time to time.

We understand that the shareholders or members of HFSB will be the Board of Trustees of HFSB and that as a signatory we will not be a shareholder or member of HFSB. However, as a signatory, we understand that we would have one vote on the appointment, re-election or removal of the directors of HFSB nominated to the board of that company from time to time.

As a signatory, we would also be invited to an annual meeting of HFSB at which the business of HFSB would be discussed, the appointment and re-election of directors would be considered and the accounts of HFSB would be presented.

Our agreement to become a signatory to the Standards is made on the basis that further details of the following matters will be made available in due course:

- details of the funding procedures for the forthcoming period. However, in no event will our requirement to make a payment to HFSB as a signatory to the Standards in the period to 31 March 2009 exceed [£   ], being the sum previously notified to us by HFSB;
- details of the procedures for participating in the votes on the appointment, re-election or removal of a director to the board of HFSB; and
- the terms of the trade mark licence for use of the HFSB name and logo.

HFSB will consider all valid applications to become a signatory to the Standards and will notify those accepted in writing formally as soon as practicable following receipt of this application form duly completed. Acceptance will be at the discretion of the Board of Trustees of HFSB. HFSB may request further information regarding the applicant before making its decision. Applicants should note that the HFSB will accept applications only from fund managers engaged in hedge fund management activity.

We understand that, in the event that we fail to comply with any of the undertakings given by us in this application, the Board of Trustees of HFSB may, at their sole discretion, revoke their acceptance of us as a signatory. In the event that we do so cease to be a signatory we will not hold ourselves out in any way as a signatory and in particular will cease to communicate in our marketing materials and/or to display on our website that we are a signatory to the Standards.

No responsibility, duty of care or liability whatsoever (whether in contract or tort or otherwise including, but not limited to, negligence) is or will be accepted by HFSB or the Board of Trustees of HFSB to signatories, investors or any other person in connection with the Standards or any Conformity Statement made by any signatory.

HFSB and the Board of Trustees of HFSB do not accept any responsibility or liability for any loss or damage caused to any person who acts or refrains from acting as a result of anything contained in or omitted from the Standards or any Conformity Statement made by any signatory or in reliance on the provisions of or material in the Standards or any Conformity Statement made by any signatory, whether such loss or damage is caused by negligence or otherwise.

Any personal details which are provided to HFSB will be used only for the purposes of contacting signatory organisations in connection with their status as a signatory or in connection with materials published by or events organised by HFSB or by third parties.

This application form and our status as a signatory shall be governed by, and construed in accordance with, English law.

Please complete the details below.

Name of signatory Organisation:……………………………………………………………

Name of person duly authorised person signing this form:…………………………………..

Signature:……………………….... Date:……………………….…

Please return this completed form to HFSB at the address above.

We hereby accept this application.

……………………….…

Duly authorised for and on behalf of

Hedge Fund Standards Board Limited

Date:……………………….…

3. Conformity Statement

<u>HEDGE FUND STANDARDS BOARD LIMITED</u>

<u>CONFORMITY STATEMENT</u>

[Signatory's Letterhead]

Mrs K Williams

Hedge Fund Standards Board Limited

13th Floor, The Adelphi

1/11 John Adam Street

London WC2N 6HT

[Date]

Dear Sirs

<u>HFSB BEST PRACTICE STANDARDS – CONFORMITY STATEMENT</u>

We refer to our obligation as a signatory to the HFSB Best Practice Standards (the "**Standards**") to provide the Hedge Fund Standards Board Limited ("**HFSB**") with an annual statement of conformity with the Standards.

We hereby confirm that as at 31 December 2008:

- we make available to investors and prospective investors in hedge funds managed or advised by us, a statement (a "**Disclosure Statement**") in relation to those Standards, if any, with which we do not comply either because we are unable to comply or choose not to do so;
- we display HFSB's logo on our website and/or in relevant marketing materials provided to investors and potential investors in the hedge funds managed or advised by us; and
- we have done what we reasonably can to ensure that the fact that we are a signatory to the Standards is communicated to investors and prospective investors in the hedge funds managed or advised by us through the prospectuses or offering memoranda for such funds.

We enclose with this letter a cheque in the sum of £[ ], being the sum previously notified to us by HFSB, in respect of our contribution to the funding of HFSB for the period to 31 March [20●●].

Yours faithfully

____

For and on behalf of:

[Hedge fund manager]

No responsibility, duty of care or liability whatsoever (whether in contract or tort or otherwise including, but not limited to, negligence) is or will be accepted by HFSB or the Board of Trustees of HFSB to signatories, investors or any other person in connection with the Standards or any Conformity Statement made by any signatory.

HFSB and the Board of Trustees of HFSB do not accept any responsibility or liability for any loss or damage caused to any person who acts or refrains from acting as a result of anything contained in or omitted from the Standards or any Conformity Statement made by any signatory or in reliance on the provisions of or material in the Standards or any Conformity Statement made by any signatory, whether such loss or damage is caused by negligence or otherwise.

This Conformity Statement and our status as a signatory shall be governed by, and construed in accordance with, English law.

4. **Explanatory memorandum of Hedge Fund Standards Board, its Interim Trustees and Trustees**

<u>HEDGE FUND STANDARDS BOARD</u>

<u>HFSB, ITS INTERIM TRUSTEES AND TRUSTEES</u>

<u>EXPLANATORY MEMORANDUM</u>

No responsibility, duty of care or liability whatsoever (whether in contract or tort or otherwise including, but not limited to, negligence) is or will be accepted by HFSB or the Board of Trustees of HFSB to signatories, investors or any other person in connection with the Standards or any Conformity Statement made by any signatory.

HFSB and the Board of Trustees of HFSB do not accept any responsibility or liability for any loss or damage caused to any person who acts or refrains from acting as a result of anything contained in or omitted from the Standards or any Conformity Statement made by any signatory or in reliance on the provisions of or material in the Standards or any Conformity Statement made by any signatory, whether such loss or damage is caused by negligence or otherwise.

HEDGE FUND STANDARDS BOARD

HFSB, ITS INTERIM TRUSTEES AND TRUSTEES

EXPLANATORY MEMORANDUM

The purpose of this memorandum is to provide prospective signatories to the Hedge Fund Standards and prospective "interim members" of the board of trustees ("**Board of Trustees**") of the Hedge Fund Standards Board Limited ("**HFSB**") with information on the establishment, structure and aims of the HFSB and its Board of Trustees. It also provides details of the role of "interim" Trustees.

1. HFSB AND THE BOARD OF TRUSTEES

1.1 The Hedge Fund Working Group ("**HFWG**") has decided that, in common with similar non-profit making bodies, the appropriate body to perform the role of "guardian" of the best practice standards contained in the Final HFWG Report to be published in January 2008 (the "**Standards**") is a company limited by guarantee. The company will be incorporated in England and Wales and its name will be Hedge Fund Standards Board Limited.

1.2 The Board of Trustees for the Standards will be the board of directors of HFSB. These directors will also be the sole members of HFSB and in this capacity will each provide a guarantee of a nominal amount of £1, but will have no further funding obligation in respect of HFSB. Further funding would be met as described in section 5 below.

1.3 The Board of Trustees will be required to promote the objectives of HFSB as set out in the mandate described in section 3 below and, in so doing, have regard to stakeholder interests, including those of managers, investors and intermediaries. The intention is that the Board of Trustees, being the only members of HFSB, will be able to exercise their independent judgement free from external constraints.

2. WHAT WILL BE THE TIMING?

2.1 Initially, following publication of the HFWG Report in January 2008, there will be an interim phase of some three to four months whilst arrangements for HFSB are finalised and the Board of Trustees are appointed. During that interim phase the 14 members of the Hedge Fund Working Group, being the initial signatories to the Standards, Sir Andrew Large and Christopher Fawcett will act as "interim" Trustees.

2.2 Further details of the mandate for HFSB and the Board of Trustees can be found in section 3 below. The process for selecting the first Board of Trustees to act beyond this interim phase can be found in section 4 below.

3. HFSB'S/THE BOARD OF TRUSTEES' MANDATE

3.1 The Mandate

The Mandate will be reflected as appropriate in the Memorandum and Articles of Association of HFSB.

- An independent body to be the guardian or custodian of best practice standards for the hedge fund industry. Initially those best practice standards will be the standards set out in the Hedge Fund Working Group Final Report published in January 2008.
- Not to act as a regulator and not to interpose itself in any way between managers and the FSA or other regulators.
- To produce an annual report on conformity with the Standards by the industry.
- Not act as a trade association, which is the role of AIMA.
- To maintain a register of signatory firms available for public inspection.
- To maintain Standards which in the judgement of the Board of Trustees:
  - are up to date;
  - are set at a high standard of conduct;
  - meet the aspirations and needs of the managers;
  - reflect the expectations of investors;
  - meet the requirements of public policy;
  - respond to changes in practice and expectation; and
  - are iterated and revised in the case of existing standards and so that new standards are developed where gaps are identified.
- To maintain links with stakeholders, including managers, industry users and suppliers, AIMA, the FSA and other regulatory bodies, both within and outside the UK.
- To consider other best practice standards which may be published or promulgated in jurisdictions outside the UK.
- To recognise that the industry operates on a global basis and evaluate opportunities for, and impediments to, convergence.
- To retain a Board of Trustees whose members:
  - have skills and experience in a wide variety of sectors;
  - are of independent mind;
  - have skills and experience in governance matters;
  - are of high standing and capable of commanding respect;
  - have experience and understanding of the international dimension;
  - have a personal commitment to the success of and reputation of the industry;
  - are capable collectively of fulfilling the mandate.
- To consult publicly with all relevant stakeholders on any proposed changes to the mandate.

3.2 **Guardians or Custodians**

The Board of Trustees will be the guardian or custodian of the Standards.

3.3 **Not a Regulator**

The role of the Board of Trustees will not extend beyond being custodian of the Standards. Neither the Board of Trustees nor HFSB will act as a regulator or a self regulatory organisation of the hedge fund industry. In particular, neither the Board of Trustees nor HFSB will stand between hedge fund managers and their regulatory authority, whether the FSA or any overseas regulator. The Board of Trustees will not seek to enforce compliance with the Standards by signatories. It is expected that compliance will be achieved through market pressure, as described in more detail in the HFWG Final Report.

3.4 **Annual Report**

The Board of Trustees will produce an annual report which will review and report on the status of conformity with the Standards by the industry over the previous year. The report's approach is intended to be qualitative not quantitative.

3.5 **Not a trade association**

HFSB will not be a trade association. AIMA already fulfils this function and there is no intention that HFSB should compete with AIMA. The Board of Trustees will instead seek to co-operate and work closely with AIMA. Further details of the proposed relationship between the two organisations are set out in section 10.1 of the HFWG Final Report. In particular, it is envisaged that AIMA will produce guidance on compliance with the Standards.

3.6 **Register of Signatories**

HFSB will maintain a register of all firms who become signatories to the Standards. All 14 members of the HFWG have been signatories to the Standards from the start. The register will be made available for inspection on the HFSB's website.

3.7 Maintenance and development of the Standards

The mandate will require the Board of Trustees to review the Standards on a rolling basis and consider where changes may be needed in order to keep them, in the judgement of the Board of Trustees:

- up to date;
- recognised and respected as an important component of the financial landscape by industry members, users and suppliers, and by regulatory and supervisory bodies;
- set at a level that reflects high standards of conduct, modified as the expected standards of conduct rise over time;
- meeting the aspirations and the needs of the managers and taking into account the practical realities they face;
- reflecting the expectations of other stakeholders, in particular those of investors; and
- meeting the public policy requirements of the day.

The Board of Trustees will need to be mindful not just of the need for iteration and revision of existing Standards, but also of the need to identify gaps in the Standards and produce new or amended Standards, as appropriate, to address them.

The Board of Trustees will consult the industry and the wider public on proposed changes and/or additions to the Standards.

3.8 Liaison with stakeholders

In order to maintain the Standards in the way described above, the Board of Trustees will need to maintain links with all of the stakeholders in the industry. In addition to the hedge fund manager community and its users and suppliers, other key stakeholders include the FSA and other regulatory and supervisory bodies elsewhere in Europe and globally.

3.9 Supervisory issues

In maintaining the Standards, the Board of Trustees will also need to consider issues of greatest concern to public policy, such as financial stability, investor protection and market integrity.

3.10 Changes to the mandate

The mandate of HFSB and its Board of Trustees as set out in section 3.1 above will be reflected as appropriate in HFSB's constitution and as such will be a matter of public record. It will also be made available on HFSB's website. The constitution of HFSB will require the Board of Trustees to consult publicly with all relevant stakeholders on any changes to the mandate which the Trustees may propose to make from time to time. However, the final decision on any changes to the mandate will remain with the Trustees.

3.11 Skills and qualities required

The mandate also includes requirements as to the composition and membership of the Board of Trustees as a whole. The Board must consist of members who demonstrate the following attributes and qualities:

- a broad range of **skill sets and experience** derived from the hedge fund world, other areas of investment management and public policy related to financial services;
- an **independent mind**, and an ability to place their specialist understandings of, for example, the world of hedge fund management in a broader context
- skills and experience in **governance** matters;
- be of **high standing** and capable of commanding the respect of the hedge fund community as well as its users and regulators;
- include individuals with **international understanding**; and
- include individuals with a **personal commitment** to the success of the industry and its good reputation.

3.12 Consideration of standards in other jurisdictions

The mandate will require the Board of Trustees, when considering whether the Standards should be updated to consider other relevant best practice standards which may be published or promulgated in jurisdictions outside the UK. The purpose is to see what might be learnt from them and where convergence may be appropriate. In so doing, the Trustees will need to be mindful of proper differences stemming from variations in law and regulation and in business practice.

3.13 Convergence over time

Equally, the Board of Trustees should evaluate opportunities for, and impediments to, convergence with best practice standards in other jurisdictions**.** This will be of particular importance in areas such as valuation and risk management, which are of direct relevance to financial stability. Clearly, much could be gained by minimising the differences between best practice standards which emanate from different jurisdictions. Convergence would improve clarity for stakeholders and promote confidence in the industry in the UK and globally.

3.14 **President’s Working Group of the USA**

In the US a working group has been formed under the aegis of the president to study and make recommendations on the hedge fund industry. The President’s Working Group plans to produce their own best practice standards in the first quarter of 2008. One of the Trustees' early tasks will be to assess the scope for convergence between the two sets of standards.

4. HOW WILL THE TRUSTEES BE APPOINTED?

4.1 The first Board of Trustees following the interim phase referred to in section 2 above will be nominated by the interim Trustees (following which the interim trustees will stand down). Further details on the qualities for these Trustees can be found in section 3.11 above. Initially, the majority of the Board are likely to be practitioners with their roots in the hedge fund industry, along with others from the wider fund management industry and investors.

4.2 There have been suggestions that there should be a large number of independents on the Board of Trustees. However, it is HFWG's view that it is essential that the Standards command the continued respect of those on whom they bear, and who have constructed them. In HFWG's view, therefore, practitioners are key. As indicated in relation to the mandate, HFSB's role is to be a custodian of the Standards, not a regulator. The FSA in the UK and other regulators overseas are responsible for regulation to protect the public interest.

4.3 There will be no prescribed groups from which the Board of Trustees should be drawn and only the Board will be able to make nominations. However, following the interim phase, for practical reasons the number of Trustees will be limited to twelve.

4.4 The Board of Trustees will nominate and appoint new Trustees. Any such appointments will be subject to approval by the signatories to the Standards at the annual meeting of signatories described further in section 5 below. Each appointment will be subject to re-election by signatories at the minimum every three years, as is common for appointments to publicly listed companies in the UK.

5. HOW WILL MANAGERS SIGN UP TO THE STANDARDS?

5.1 Managers will be invited to sign up to the Standards by completing a simple application form issued by HFSB. A brief explanatory memorandum will accompany the form. By signing up to the Standards, hedge fund managers will undertake to adopt the comply or explain regime set out in the Standards and to publicise this on their websites and elsewhere as further detailed in the Final HFWG Report. Managers who sign up to the Standards will be expected to bear a share of the costs of HFSB calculated on what is intended to be an equitable basis, but with a smaller contribution expected from smaller managers. Managers who sign up to the Standards will be entitled to attend an annual meeting of signatories and vote in relation to the appointment and re-election of members of the Board of Trustees.

5.2 Further details of the procedures and costs of HFSB will be made available during the interim formation phase described at section 2 above.

5.3 In the event that a signatory fails to comply with any of the undertakings given by the signatory in the application form, the Board of Trustees may, at their sole discretion, revoke their acceptance of that manager as a signatory to the Standards. In the event that a manager does so cease to be a signatory to the Standards, they will not hold themselves out in any way as a signatory to the Standards and in particular will cease to communicate in their marketing materials and/or to display on their website that they are a signatory to the Standards.

Hedge Fund Standards Board

22 January 2008

Appendix D. Regulatory and legal status of the Standards

1. Introduction

We have taken advice from Herbert Smith LLP in relation to the potential advantages and disadvantages of the publication and adoption of the Standards from a UK regulatory and legal perspective. We have also had a presentation from litigators at Schulte Roth & Zabel LLP's New York Office concerning the regulatory and civil litigation implications in the United States of publication and adoption of the Standards. The purpose of this section of our Report is to examine these issues in such a way as will assist hedge fund managers to reach an informed view as to whether: (i) becoming a signatory to the Standards is likely to be beneficial for an individual firm; and (ii) the publication and adoption of the Standards is likely to benefit the UK hedge fund management industry as a whole. It also seeks to explain the potential UK and US regulatory and legal liability associated with the publication and adoption of the Standards.

2. What is the regulatory status of the Standards in the UK?

Grounded in the FSA's Principles for Business

The FSA's 11 Principles for Business and Principles-based regulation are a familiar feature of the UK regulatory landscape. The FSA is, however, now driving towards more Principles-based regulation ("MPBR"). This has three key features: first, a clear move away from reliance on detailed, prescriptive rules in favour of high-level, broadly stated principles to set the Standards by which UK regulated firms must conduct their business; second, a change of emphasis by the FSA away from looking at the processes carried out by regulated firms, towards the specification of outcomes; and, third, an intensified reliance on the senior management of regulated firms to be closely involved in developing, monitoring and updating their internal policies and processes in order to address the requirements of the FSA Principles.

Under MPBR the FSA, recognising that regulated firms are better placed to determine the processes that will achieve the desired regulatory outcomes, will in effect use the FSA Principles to articulate the desired outcomes and then leave the firms to decide for themselves how to achieve those outcomes.

Role of industry guidance

The FSA envisages a greater role for sector-specific industry guidance in the new world of MPBR. Such industry guidance will form part of the overall regulatory landscape to be taken into account when firms work out how they should go about achieving particular outcomes specified by the FSA. There are two types of industry guidance for these purposes: guidance that has been confirmed by the FSA and other (unconfirmed) guidance. The Standards will be unconfirmed guidance.

FSA confirmed industry guidance will be accorded "sturdy breakwater" status. This means that the FSA will not take action against any regulated firm that has adhered to confirmed industry guidance in force at the relevant time. However, the absence of "sturdy breakwater" status for the Standards does not mean that we believe they are in any way "sub-standard" for their purpose. Real practical protection for managers should we feel be provided in that where all relevant firms were acting on the basis that the Standards were reasonable, this should in our view inform any proper interpretation of that the FSA Principles required.

The high level nature of the FSA Principles means that there will often be more than one way to comply with them. Often the judgment turns on what it is reasonable and proportionate for firms to do and if a firm is complying with widely accepted industry standards it will in our view be more difficult to argue that this is not a reasonable approach to complying with the relevant FSA Principles in the absence of more detailed rules or guidance from the FSA. Furthermore, we believe there is real value in the UK hedge fund industry seeking proactively to shape the standards of conduct by which its members are likely to be judged in the event of a challenge by the FSA. Appropriately framed industry guidance such as this should in our view influence that process in a way that takes into account the industry's own perspective. For this reason it is vital that the Standards reflect current market practice and regulation and do not become out of date. It should be emphasised, however, that simply adhering to the Standards does not provide any guarantee of compliance with the FSA's requirements, and in no way obviates the need for each firm to satisfy itself that it is complying with the requirements of the FSA's rules.

There are two main reasons why we have not sought FSA confirmed guidance status for the Standards. First, the purpose of the Standards is to promulgate best practice in the UK hedge fund management industry at a benchmark level reflecting the standard of reasonable skill and care we consider is likely to be applied by the English court in civil negligence claims. In contrast, the FSA consistently describes its Principles as setting the minimum standards to which regulated firms should adhere. Second, the "comply or explain" approach inherent in our Standards recognises the diversity of the hedge fund management sector. We believe that a diverse, rather than a "one size fits all", approach is appropriate as being consistent with the spirit of MPBR; this inherent diversity is, however, unlikely to lend itself to the FSA confirmation process.

3. What is the likely regulatory impact of the Standards?

Is there a risk that the Standards could effectively become mandatory rules?

There is an argument that the promulgation of Standards such as these could blur the line between minimum standards and best practice. While a particular hedge fund manager may consider it prudent to seek what may be a "safety in numbers" benefit associated with a "comply" approach to the Standards, this does not mean that this approach is the only way to comply with the FSA Principles (and indeed, as noted above, such an approach would not constitute a guarantee of compliance with the FSA's requirements).

Hedge fund managers that choose to take an "explain" approach to any of the Standards should derive comfort from the fact that the FSA has stated that failure by a regulated firm to adhere to industry guidance does not of itself mean that there has been a breach of the FSA Principles.

What is the risk of not having the Standards?

Given the FSA's increasing scrutiny of hedge fund managers, for the industry simply to do nothing must give rise to a risk over time of having additional regulatory requirements imposed by the FSA in a form that the industry considers unpalatable. This may involve new FSA rules or the issue of informal guidance on the application of the Principles or other FSA rules to hedge fund managers.

Without the benefit of the Standards there is, in our view, a risk of greater uncertainty as to the standards of conduct by which hedge fund managers would be judged in any FSA enforcement action under the FSA Principles. As already mentioned, there is value in the industry seeking to influence the way in which those standards are assessed through appropriately framed industry guidance.

We believe that, in the UK at least, an industry-wide approach to the improvement of existing practices could help to convince the FSA that further formal regulation is not required. The FSA’s stated policy is to regulate where there is evidence of a market failure. In our view, industry guidance such as that embodied in the Standards can assist in pre-empting or addressing a market failure, thereby reducing the risk of regulatory intervention.

4. What is the likely impact of the Standards on claims against hedge fund managers under English law in contract and tort

How are claims likely to arise?

There are a number of ways in which claims against hedge fund managers may arise. These include: alleged breaches of an investment management agreement, allegations that the hedge fund manager has induced an investor to invest by making representations which constitute negligent or fraudulent misstatements or that the management of the fund has been negligent, including in relation to valuations.

Claims may also be made by investors against the fund itself for breach of contract and/or against the directors of the fund who may also be partners in (or directors of) the hedge fund manager for breach of duty, fiduciary or otherwise. In certain circumstances, where the fund becomes insolvent and a liquidator is appointed, statutory claims may also be made against the fund's directors.

How might the Standards affect such claims?

Where there are allegations that a manager's conduct has caused loss, one of the key issues in determining how liability may arise in both contract and tort is the way the English court would look at the manager's conduct. Broadly, English contract law permits parties to a contract to determine what their respective rights and obligations are and the court will not interfere except in limited circumstances. English law permits parties to a contract to limit or exclude liability (including for misrepresentation), although that may in certain circumstances be subject to a test of "reasonableness" under the Unfair Contract Terms Act 1977. In the law of tort, the English court will approach a claim in negligence by seeking to establish, first, what the relevant standards of conduct are (that is, what is the level of reasonable skill and care required in the performance of the defendant's duties) and, second, whether the defendant to a claim has fallen short of those standards in a way which has caused the relevant loss. Any express limitation of liability for negligence by a hedge fund manager will only be effective if it satisfies the statutory test of "reasonableness" referred to above.

Conformity with the Standards, whether through compliance or an explanation of non-compliance, should help avoid a mismatch of expectations about the duties which the hedge fund manager has undertaken. In simple terms, provided a manager's explanation of non-compliance is made with sufficient clarity and at the right time, that should operate to define and limit the hedge fund manager's obligations and duties under English law; a claimant could not in those circumstances successfully maintain that the Standards (or indeed any more general standards) represent the benchmark by which the conduct of the hedge fund manager should be judged. It follows, however, that hedge fund managers will need to do what they have asserted that they will do. This is because the manager's statement as to how it intends to comply with the Standards, or the manner of its explanation as to non-compliance will make it easier for a claimant to evidence its claim of what the expected standards of behaviour in question were, and to assert that the manager fell below those standards.

Inasmuch as the client to whom the manager owes a duty, whether in tort or in contract, is the hedge fund itself the nature and extent of these duties can be agreed between those two parties so as to reflect compliance with the standards and explanation of non-compliance, where relevant.

Investors in the funds are not able to bring a contractual claim against the manager so the Standards have no impact in that regard. There always remains the possibility of investors bringing claims in tort in respect of negligent management or negligent misstatement. In this case, it would not be practical - at least with existing investors - to obtain written confirmation that they accepted that the manager did not comply with all the Standards and that the manager's duty of care should be limited accordingly. This could, however, be achieved as regards new investors who could acknowledge this in their subscription documentation.

At present, and irrespective of the publication of the Standards, a manager already runs the risk that the court will find that its behaviour has fallen short of the standard of care expected of the "reasonable hedge fund manager". What the Standards do is to bring clarity to what is the requisite standard of care and, for example, if numerous smaller managers choose to explain non-compliance with a particular Standard then it must be strongly arguable that the behaviour required by the relevant Standard is more onerous than should be expected of the "reasonable [smaller] hedge fund manager" such that an explained decision not to comply should not result in liability even if this has not been agreed with an individual investor.

Claims against hedge fund managers in fraud will normally be based on dishonest conduct (for example theft), alternatively on representations by the manager which were known to be untruthful or were reckless, in the sense that the manager did not care whether they were true or false. The Standards are likely to be of less relevance in this area of claims.

Broadly, we believe that the Standards reflect what an English court is likely to say would constitute the duty of reasonable skill and care to be expected of a competent hedge fund manager. The benefit of clarity through the "comply or explain" approach is in any event highly desirable in protecting a hedge fund manager from claims based upon expectations which the hedge fund manager never intended to meet.

5. What is the likely impact of the Standards from the perspective of US regulatory actions and civil litigation against hedge fund managers under the laws of the United States.

The role of industry standards in the United States

There is no system in the United States for official recognition, approval or adoption of industry standards by the US Securities and Exchange Commission ("SEC"). The hedge fund industry typically – though not always – gets the opportunity to provide comments to the SEC on the SEC's proposed rulemakings. The closest the US regulatory system comes to the UK's "confirmed guidance" concept is the self-regulatory organisation ("SRO") model, perhaps represented best by the NYSE and NASD (which recently merged their previously separate regulatory arms into the Financial Industry Regulatory Association (“FINRA”)). The SROs are officially recognised by the SEC and their rules must be approved by the SEC before those rules take effect. Once effective, SRO rules are binding upon their members and the SROs have their own enforcement arms to ensure compliance with SRO rules. There is no effort underway in the US to set up an SRO for the hedge fund industry and no one expects a hedge fund SRO to be established any time soon.

Like the UK, the hedge fund industry in the US is under increasing scrutiny by the SEC and other federal and state regulators. If a broad consensus emerges regarding best practices for hedge funds, this could be useful in educating US regulators, demystifying the industry and forestalling future efforts to impose inappropriate government regulation of the industry in the United States. The SEC may only bring enforcement actions based on violations of the US securities laws, but many of those laws are broadly prescriptive and, therefore, the SEC may look to the industry best practice standards to give guidance as to the application of those laws.

The potential impact of industry standards on civil litigation in the United States against fund managers

In deciding whether to "comply or explain" with respect to industry standards, the most important thing for a manager to do is act in a clear, honest manner in dealing with the fund and its investors. Importantly, a manager could face liability for telling the fund/investors that it is going to abide by industry best practices but then failing to do so if that failure causes investor loss. But that is no different from a manager’s obligation to live up to any other contractual undertaking.

If the manager clearly discloses to the fund that it is not going to abide by certain industry best practices, the manager should not face any contractual liability for not adhering to those industry best practices (to the extent that the conduct is not fraudulent or otherwise actionable even in the absence of industry best practices standards). Similarly, although a manager might be sued by the fund and/or an actual or prospective investor for securities or common law fraud if the manager represents that it is going to abide by industry standards and then fails to do so, the manager should not face a fraud claim if it clearly explains that it does not intend to follow industry standards (and then acts in accordance with those clear disclosures).

From a tort perspective, in determining whether a manager engaged in negligence or gross negligence, a court (as well as a jury) may take into account industry best practice standards in determining the standard of care of the reasonably prudent investment adviser. In the US, determining the proper standard of care is a function of the judge, often as informed by a “battle of the experts.” Ultimately, however, it is for the jury to apply that standard of care to the facts before it and determine if the standard of care was breached. Here too, a “battle of the experts” will be an important part of that process. Whether or not industry best practice standards would even be admissible in evidence in a trial of claims against a manager to assist in determining the appropriate standard of care is an open question in the US. In the analogous context of auditor’s liability cases, some courts have admitted into evidence the audit firm’s internal audit manual while other courts have held such material to be inadmissible. Thus, industry best practices standards may or may not be considered by a court in adjudicating cases brought against managers.

Whether or not industry best practices will be used by a court in determining the applicable standard of care against which a manager's actions will be judged in the United States, we believe it is beneficial for the industry to seek to influence the standard of care under which they will be judged in the future. At worst, industry best practices will be ignored by a court in civil litigation.

6. Conclusion

As a consequence of the advice we have received, we have concluded that it is indeed appropriate to formulate best practice standards such as these for hedge fund managers. We consider that there is a real advantage for the industry in setting the Standards and for individual hedge fund managers in choosing to conform to the Standards on a "comply or explain" basis. We therefore urge hedge fund managers to think seriously about becoming signatories to the Standards.

Appendix E. 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)	▪ Gross assets/equity ▪ Gross debt/equity	▪ Does not incorporate on-balance sheet hedges and off-balance sheet instruments
	▪ Net assets/equity ▪ Net debt/equity	▪ Does incorporate on-balance sheet hedges (therefore "net"), but does not include off-balance sheet instruments
Risk based	▪ Portfolio volatility/equity ▪ VAR/equity ▪ Stress loss/equity ▪ Other loss measure/equity	▪ Usually incorporates all (on- and off-balance sheet) hedge positions ▪ But does not account for mitigating measures by manager in times of distress

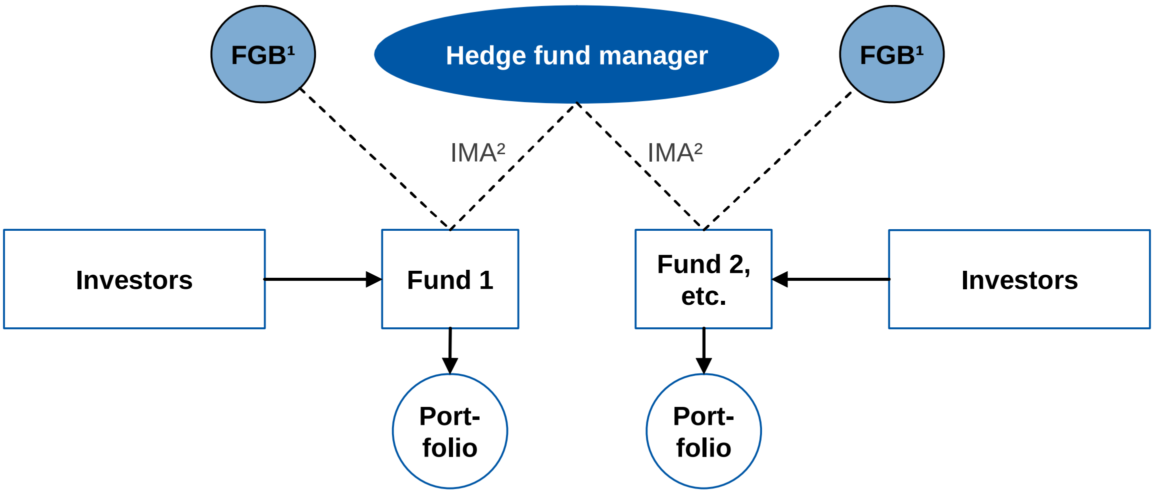
Appendix F. Areas of concern from a smaller manager perspective

Area	Concern raised	Assessment	HFWG perspective/ how addressed
Valuation	"False incentive" provision (i.e. valuation team should not be remunerated according to the value of, or increase in the value of, the fund's portfolio).	▪ To attract and retain personnel, compensation of staff and partners working on valuation in smaller firms is often linked to fund performance	▪ The HFWG considers this as a source of conflict. It therefore recommends that managers should not link remuneration of the valuation team directly to fund performance. Any deviations can be explained as part of the comply or explain regime.
Portfolio risk	Segregation of duties in risk management (separated risk monitoring).	▪ Smaller managers (eg with fewer than 10 staff) might not be able to separate responsibility for portfolio management and risk monitoring	▪ The HFWG acknowledges this difficulty and has amended the Standard such that if a smaller manager considers that such segregation is impracticable, it may instead simply disclose that fact to investors.
Operational risk	Some requirements may be costly/ burdensome for smaller managers to meet, in particular automation of trading and execution, infrastructure for disaster recovery and IT security.	▪ Automation of trading and execution: This may be less advanced with smaller managers, who may rely to a larger extent on manual handling.	▪ The HFWG agrees and has therefore amended the Standards. Electronic matching and confirmation systems are now included only as guidance as to how the Standard might be complied with rather than a prescriptive requirement..
		▪ Disaster recovery: Having a communication/ contingency plan and conducting regular testing of infrastructure does not add a significant extra burden. However, offsite facilities / back-up office space and infrastructure can be costly.	▪ The guidance to the Standard already highlights that the extensiveness of disaster recovery measures should depend on a manager's scale.

Area	Concern raised	Assessment	HFWG perspective/ how addressed
		▪ IT security: Full-scale offsite back-up facilities can be costly and might not be feasible for smaller managers.	▪ The HFWG believes that having data back-up (eg mirrored sites to process the core workload) is crucial to any sound hedge fund manager’s operation, but agrees that the level of sophistication (and cost) should be a function of the size of the manager. The guidance has been amended to reflect this.

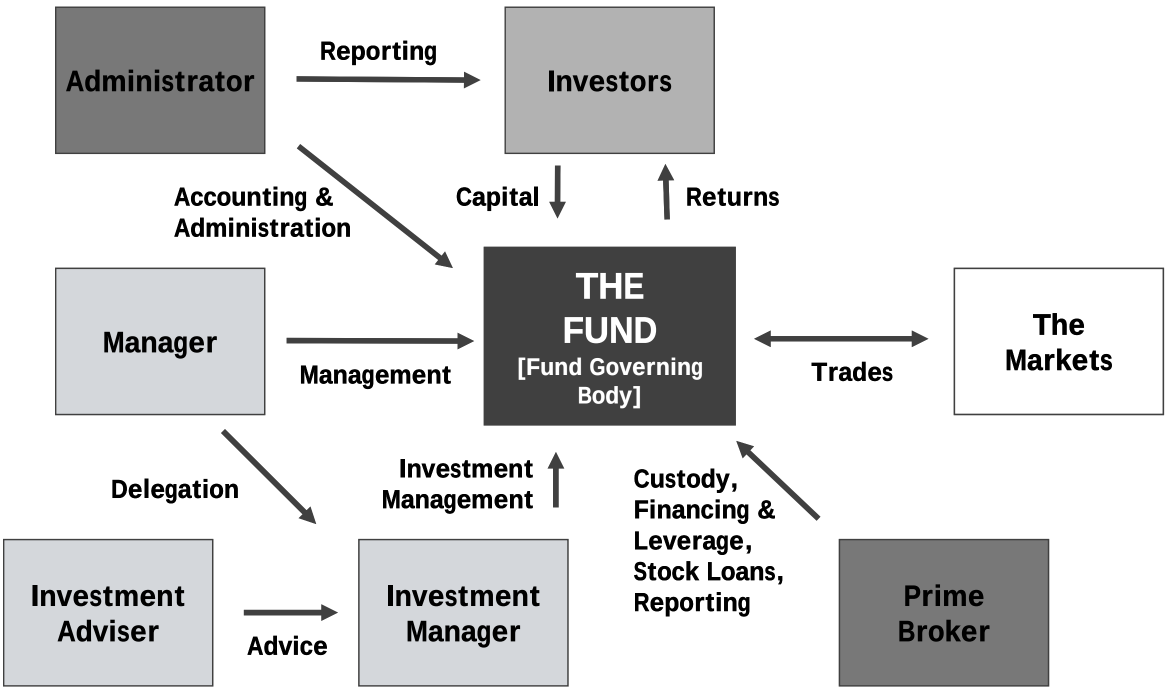
Appendix G. Illustration of typical hedge fund structure

Simplified illustration:



1. Fund Governing Body
2. Investment Management Agreement

Illustration including other parties (Source: AIMA):



Appendix H. Financial stability dimension

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

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

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

- First, where are they, and how big are they? Trying to identify their location and to measure their size might suggest that an attempt be made to analyse the positions of individual firms and in aggregation. The problem here is partly the proprietary nature of the information. Even if the data could be collected in a timely manner, the speed with which risk positions can be transferred and the complexity of the analysis of positions means that any theoretical study of positions would be fraught with problems of interpretation.
- Second, some hedge funds do indeed have big positions. But so do almost all the major global investment and commercial banks through their proprietary trading desks as well as their customer risk-taking activities. This is also true for a variety of other major investors including central banks, sovereign wealth funds, corporations and long-only asset managers. Many of these are just as capable as hedge funds of trying to shift positions in periods of stress. The value of looking at hedge fund positions in isolation would to that extent be reduced.
- Third, concentrations of risk, even with no change in the underlying assets, are dynamic. As we have seen recently, asset classes which appear not to be correlated can become highly correlated at times of stress and hence cause unexpected forms of concentration to appear at the very time that they are least welcome. One response has been calls for a "register" type approach to managers' risk positions. Such calls have lessened in recent years as the issues mentioned above have become better understood and the realisation has grown that using whatever data might be compiled would contain its own hazards. For this reason, the approach taken in this report – and this is a major strand in the best practice Standards – is for firms and their supervisors to pay significant attention to risk management.
- If supervisors realise that it is not easy to make judgements about financial stability by collecting and analysing data on concentration positions, a powerful alternative mitigant of concern is for them to have confidence in the robustness of the risk management frameworks of hedge fund managers: for example, to understand how

such firms think about their risks, how they measure them and how they control and manage them.

- This is why we have emphasised the "framework" of risk management in this report. It is not just the investors in the funds who need to have comfort that risks are well managed, but it is also important for the broader public interest.

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

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

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

Appendix I. Consultation questions

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

Part 2	Page*	Consultation question
Introduction	8	The Standards proposed in this document are largely based on disclosure rather than more prescriptive description of behaviour and practices. Would smaller hedge fund managers find such a disclosure-based approach difficult to comply with?
		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 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: hard-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?

Part 2	Page*	Consultation question
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"?
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?

* Pagination in Part 1 and Part 2 of the original consultation paper

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

Net Asset Value and Share Price calculation	▪ 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	▪ Subscriptions/Redemptions & Transfers – 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 – 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 – 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.

Transaction Processing	▪ 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	▪ Pricing control ▪ Error and breach reporting
Accounting and Financial	▪ Accounting standards used ▪ Filing of accounts
Corporate Secretarial	▪ 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 K. HFSB Interim Trustees

All 14 members of HFWG have become interim Trustees of HFSB with effect from 22 January 2008 and will remain in that role until the permanent Board of Trustees is in place. In addition Sir Andrew Large will act as interim chairman; Christopher Fawcett, Chairman of AIMA is also a Trustee.

Sir Andrew Large – Interim Chairman

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

Appendix L. Acknowledgements

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

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

- Oliver Wyman – for full time operational, project management and content support for the project.
- Herbert Smith LLP – for legal counsel and major help in drafting.
- Simmons & Simmons and Dechert LLP – for their help in reviewing and commenting on the Standards.
- Schulte Roth & Zabel LLP – for US legal input.
- Quiller Consultants – for public handling.
- Ernst & Young – for general advice, particularly in the accounting and governance fields.
- Marshall Wace – for providing office space and infrastructure support

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

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

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

Sir Andrew Large
January 2008

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