Hedge Fund Standards: Consultation Paper

From the Hedge Funds Working Group

A response by CFA Society of the UK

The CFA Society of the UK (CFA UK) represents the interests of over 7,000 leading members of the investment industry, many of whom either manage or invest in hedge funds. The society, which was founded in 1955, is one of the largest member societies of the CFA Institute and is committed to leading the development of the investment industry through the promotion of the highest ethical standards and through the provision of education, professional development, advocacy, information and career support on behalf of its members. CFA UK supports the CFA, ASIP and IMC designations. Most members hold either the Chartered Financial Analyst (CFA), or Associate of the Society of Investment Professionals (ASIP) designation. The ASIP designation is held by those who successfully completed the Associate examinations. CFA Institute is best known for developing and administering the CFA curriculum and examinations and issuing the CFA charter. CFA Institute's mission is to lead the investment profession globally by setting the highest standards of ethics, education and professional excellence.

Most CFA UK members also belong to the CFA Institute and reaffirm annually their adherence to its Standards of Professional conduct. Both CFA UK and CFA Institute are committed to providing members with a wide range of professional development opportunities. All members are encouraged to undertake ongoing post-qualification professional development.

CFA UK is the awarding body for the IMC, the benchmark entry-level qualification for those working in investment management in the UK. The examination is accredited by the Qualifications and Curriculum Authority (QCA) and is designated an 'appropriate examination' by the Financial Services Skills Council (FSSC) for the purposes of the Financial Services Authority's training and competence requirements. The IMC is held by over 15,000 investment professionals.

Introductory comments

We welcome the opportunity to respond to the Hedge Fund Working Group (HFWG) consultation paper (the "Paper"). We support the HFWG's efforts to improve standards for this rapidly growing and increasingly important but complex area of the investment industry and congratulate the HFWG on its initiative. In particular we support the paper's overall

approach and the thrust of its arguments with its emphasis on disclosure rather than regulation. One concern underlying most of our comments is that the success of most of the proposals in the Paper depends upon the complex balance of power between the managers, the governing bodies and the investors in hedge funds. We address this issue and the matter of the necessary and sufficient conditions for a 'comply or explain' regime to function successfully in our response below.

We question the relevance of the view mentioned in Part 1 p11 that "many hedge fund strategies are arguably less risky and less volatile than "long-only" investment in familiar instruments such as debt securities and equities." We argue that this language could be misleading. A large number of hedge funds appear to close each year. According to Peter Clarke, the CEO of Man Group the figure is somewhere between 5% and 7% per annum[1]. Although by no means all of these fund closures are fund failures, this is nonetheless a high figure compared with onshore funds. Investors should be aware, before investing, of this high closure rate.

Equally, whilst we agree that many funds are not activist, there is no evidence that activism has anything to do with market stability. In a lengthy report (dated 21st November 2007) on hedge funds and financial stability to the EU Parliament written by academics at by Erasmus University in Rotterdam neither the word "activist" nor the word "activism" appears once. The society also disagrees with the implication in Part 2 section 6 that activism leads to short-termism; activism is frequently long-term in nature.

Governance

We understand that, unlike listed companies where the board is appointed by shareholders, the members of most hedge funds' governing bodies or boards are appointed by the hedge fund managers. These same managers often also have the power to terminate a board member's appointment. It is, therefore, questionable whether hedge fund boards are truly independent from managers. Hence, a Board that is expected to exercise independent judgement or control over a manager's activities will face a conflict of interest to the detriment of the fund's investors, in effect, potentially undermining the structures that are intended to make hedge fund managers accountable. This is an important issue which requires further consideration.

In addition, we are unconvinced that the 'comply or explain' approach suggested in part 1 section 4.1,will work in practice as the HFWG proposes. For such a regime to work, it is necessary that all participants either comply with the rules or explain why they have not. It is equally important that those to whom explanations are given have some power to take action if they do not accept the explanations of non-compliance. As an example, the Combined Code in the UK is effective because it is supported by the FSA as Listing Authority which requires compliance or explanation and because shareholders who do not accept an explanation of non-compliance have the power through engagement with management or at AGMs or EGMs to take action. It is not at all clear what power there would be to stop hedge funds from failing to comply or to explain and it is clear that investors have very limited power over the actions of the managers or the governing body in the event of non-compliance and inadequate or unacceptable explanation.

The Paper suggests that peer group pressure will encourage compliance. However, the hedge fund industry has a large number of small players which, unlike the larger firms, do not have the necessary infrastructure or resources to handle all the standards proposed without the risk of stifling their business.

[1] Financial Times interview on 20 November 2007.

The CFA Institute Centre recently published a paper titled ‘Self-Regulation in Today’s Securities Markets’ that makes specific reference to the ‘Characteristics of Effective Self-Regulatory Systems’ and indeed those of ineffective systems[3]. The paper points out that ‘mutual benefit’ is a key success factor. We are concerned that the Report’s standards of best practice are too prescriptive for the ‘rank and file’ hedge fund manager, and therefore fear this proposal will not receive the support to depth of support necessary to make it effective. To reiterate the point made above, investors will be unable to exercise leverage over the managers to force compliance or an adequate explanation for non-compliance due to the lack of direct accountability to investors by hedge fund managers. Measures should be put in place to counter this governance weakness.

Disclosure

Part 2, 2.1.3 refers to disclosure in the event of a change in investment policy. We believe that investors must be able to make informed choices in advance of a proposed change in investment style. This in practicality could be very difficult as we recognise that hedge fund investing is often opportunistic. We would encourage the HRWG to explore this area further.

We elaborate on this point in our response to Q16 below but we would emphasise that disclosure of positions is an important matter which the Paper appears to overlook and also we believe that the models used to value illiquid securities should be disclosed in some detail.

Fund valuation

We are strongly in favour of independent valuation of a fund’s assets and the calculation of fees payable to the manager. Whilst this may put pressure on smaller firms we believe that internal valuation of illiquid asset leaves too much scope for less-than-independent calculations. The issues surrounding the balance of power within a hedge fund also impact the valuation of funds. Internal fund administrators are also appointed by the managers and so could face a conflict of interest when required to value illiquid assets. Furthermore, as the governing body is not independent from fund managers the internal fund administrators would have no independent route of appeal should such a conflict arise.

The increase in the number of independent third party valuers who use standardised approaches should alleviate the difficulty for outsiders to value illiquid assets. If this should prove too expensive for smaller players, we would recommend that any internal valuations should be subject to a requirement for independent valuation. Regardless of the method used to value an asset, professional investors should be aware that any valuation is only a snapshot of values at a given point in time. Investors may not be able to realise their assets at the valued prices, especially in a crisis situation or if the assets are illiquid. See our comments above under “Disclosure” concerning the need for clarity about the models used.

We welcome the endorsement by the HFWG of the Global Investment Performance Standards (GIPS). These globally recognised standards, managed by CFA Institute, have proved very successful in providing meaningful comparative data for investors. We recognise that further work is required to ensure the full relevance of GIPS to the requirements of hedge fund investors. The CFA Institute and its partners are currently working on this project.

Finally, the retailisation of hedge funds gives rise to concerns about the level of risks faced by investors in open-ended funds that are difficult to value. Whilst we believe that it would be severely restrictive to prohibit hedge funds from investing in illiquid investments, we recognise that this practice can create problems concerning valuations and the consequent potential dilution of some investors’ interests to the benefit of others. We would therefore

recommend that the HFWG reconsiders the suitability of open-end hedge funds for retail investors.

Response to questions

Q1	Are there further issues that should be addressed by the HFWG?
	There are issues of detail (e.g. disclosure) but these are addressed below in our response. We do not perceive major areas of omission in this comprehensive review.
Q2	Are there any comments/observations on the way in which we envisage conformity with the standards
	CFA UK strongly supports the “comply or explain” approach. As explained above, we have considerable doubt about whether it can prove effective in the absence of any power on the part of those to whom explanations are being given and in the absence of any means to ensure that the third option (viz, non-compliance coupled with non-explanation) is not possible. This needs further consideration and we refer to this under governance under question 3.
Q3	What would be the best forum for disclosing conformity with the standards?
	We believe that disclosure should be on the websites of both the hedge fund manager and the hedge fund itself and in the annual reports of both these entities. We also believe that the successor body of the HFWG should maintain a database of compliant firms.
Q4	Would improvements to visibility, as suggested above, be useful?
	We unequivocally support measures to increase the level of publicly available information on the hedge fund sector and the proposed statements of conformity to any standards of best practice/governance that gain wide recognition within the sector, from regulators, and professional bodies. For individual firms we would support increased transparency about the fund, the fund manager and the fund’s significant counterparties and relevant regulators.
Q5	What other areas of information related to the hedge fund industry would be of value, taking into account the constraints mentioned?
	Performance data within the sector is frequently coloured by survivorship bias. A public record of the number of funds that cease to exist or become dormant, and some generic data, would also provide valuable insight for investor risk.
Q6	Would stakeholders see merit in firms who conform to the standards confirming this on their websites?
	As stated in our answer to Q3 above, the answer is a forceful “yes”.
Q7	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?
	This seems to be a useful proposal but in order to have the necessary credibility the Board of Trustees, must be demonstrably independent and drawn form a wide pool of hedge fund investors and possibly regulators, and not just hedge fund managers. We feel it is very important that users have a strong voice on the Board of Trustees in order to maintain the momentum of these helpful proposals and also, importantly, to provide both the perception and the reality of appropriate balance.
Q8	If not, what other governance structure would be suitable?
	N/A

Q9	What mandate should the trustees have?
	If the HFWG intends to publish the Mandate, it should be drawn up by a wider group than those who make up the HFWG. We would be happy to assist in this process.
Q10	Should the funding be wholly provided by the hedge fund industry, or should the industry's users contribute?
	It is difficult to see what source of funding would be appropriate other than the industry itself.
Q11	Do industry practitioners agree that there is a need for more hedge fund industry specific education training, and if so, what relevant areas should the curriculum cover?
	There is always a need to update and improve educational material and training in such a dynamically evolving industry as investment management. However, the HFWG is incorrect in asserting that "there is no widely used qualification in the UK that combines all the particular features of the hedge fund industry". For more than 40 years CFA Institute and its predecessor organizations have managed the educational content, examination and award of the Chartered Financial Analyst (CFA) designation which is recognized globally (not solely in the US or the UK) as the industry gold standard. CFA Institute has nearly 97,000 members including more than 13,000 in Europe and 6,500 in the UK. The CFA programme is respected not only for its constantly updated body of knowledge but also for its challenging examinations. These examinations include ethical and professional standards, equity analysis, debt analysis, derivatives analysis, alternative investments, financial statement analysis, quantitative techniques, economics, corporate finance, portfolio management, risk management, asset allocation and performance measurement. Although CFA Institute members are not required to state what branch of investment they work in, of those who have done so, more than 4,300 work explicitly in hedge funds or funds of hedge funds. Over 11,000 work in investment banking and thousands more work in other areas which are exposed to the hedge fund sector. We encourage the HFWG to engage with CFA Institute to examine the current CFA syllabus and, if necessary, to make suggestions for inclusion of any material which might be necessary for further broadening of the body of knowledge.
Q12	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)
	See the answer to Q11 above.
Q13	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?
	Possibly, as implied in our introductory comments on "Governance" above but the alternative approach of regulation would be more demanding.
Q14	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?

	We are not commenting as this question is targeted at funds.
Q15	Do the best practice standards strike the right balance between disclosure on the one hand, and the need for flexibility and innovation on the other?
	Yes, with the exception of the caveats mentioned with regards to the difficulties in enforcing a comply-or-explain structure as noted in our discussion about “Governance” above, and with regards to the burdens they might create for smaller firms discussed in our answer to question 13.
Q16	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?
	We are concerned about the following omissions and believe that:- 1) full disclosure to hedge fund investors, potential investor, significant counterparties and relevant regulators should be made of the financial arrangements between hedge funds and their prime brokers including regular disclosure of the total of fees of all sorts incurred by hedge funds (as opposed to fees paid by the hedge fund managers themselves) and effectively paid by investors in these funds. 2) any transaction or other fees paid by third parties to hedge fund managers should be fully disclosed to hedge fund investors, potential investor, significant counterparties and relevant regulators. 3) portfolio positions should be disclosed to investors (not to the general public) clearly and frequently. Disclosure to investors is barely treated in the Paper. We are aware that some hedge fund managers are concerned that this could lead to leakage into the public domain and thus to impairment of the value of their positions. We would urge hedge fund managers to disclose how they intend to deal with this problem. Hedge fund managers must determine how best to establish lines of communication that fit their circumstances and that enable their investors to evaluate their financial status. 4) managers should disclose any historical regulatory or disciplinary action taken against the firm or any of its personnel. 5) managers should disclose trade allocation polices between portfolios. 6) managers should disclose any significant personnel or organisational changes within the organisation.
Q17	Would the proposed disclosures give investors a sufficient understanding of relevant commercial terms, such as fees, expenses and termination rights?
	Subject to our answer to Q 16 above, yes.

Q18	Are additional disclosure standards required for either creditors or other third parties to enable them to make well-informed decisions?
	See response to question 16.
Q19	Given the importance of independence from the portfolio management function, are the improved valuation policies and procedures sufficient to meet needs of investors?
	No. We believe that valuation should always be carried out by third parties such as academics or qualified agencies which would arise to fill the vacuum. The risks inherent in in-house valuation in organisations with huge internal conflicts are both obvious and unacceptable.
Q20	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?
	Yes
Q21	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?
	Subject to our answers to Q19 and 20, yes.
Q22	Are there other aspects of the proposed risk framework which are not laid out in the practices which should be considered?
	The framework is satisfactory.
Q23	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.
	The proposals are satisfactory except that we do have general concerns about a very sudden counterparty failure. Specifically most such assessments assume that if a relationship is fully collateralized at any point in time the failure of a counterparty will not result in loss. This may not be true if the counterparty's sudden failure results in a major and immediate move in the relevant market and the position cannot be replicated. Collateral should always be with third parties.
Q24	Will the above approaches provide investors and counterparties with sufficient understanding and comfort about the handling of risk?
	Apart from the issue raised in our response to Q23 above, we believe investors and counterparties would benefit from such an approach.
Q25	Have we adequately covered the main issues in relation to this increasingly important area?
	We are very concerned that hedge fund governing bodies are appointed by the hedge fund managers. Thus the overseers are appointed and potentially dismissed by those whom they ostensibly oversee. It is conceivable that a hedge fund management could dismiss its governing body and not the opposite. This contrasts with the position with Investment Trust boards in the UK which can and do replace under-performing managers. This needs further careful consideration and we would recommend that HFWG encourages hedge funds to pass control of the governing body to investors to make it comparable to a Board of Directors.
Q26	Are the governance and disclosure standards a useful addition towards market

	integrity?
	Broadly yes but as stated in our answer to Q25, more consideration is required. With respect to market abuse, we believe that there must be a clear high-level principle attached to the best practice in 6.1.3. to read "Hedge fund managers must uphold the rules governing capital markets; they should ensure that they have internal compliance arrangements to identify, detect and prevent breaches of market abuse and regulations".
Q27	Would other market participants equally value clarification or improved definition as to what constitutes a 'concert party'?
	Yes, although strictly speaking "concert party" is a term used by the Panel of Takeovers and Mergers rather than the FSA. We would welcome clarification of the general issues raised in Part 2, Section 6.1.4.
Q28	To what extent would stakeholders value this new requirement?
	We believe that this requirement would be very welcome in respect of both transparency and good corporate governance. We are concerned by the suggestion that "not all firms will be in a position to vote all proxies" and would suggest that if hedge fund managers do not wish (or are unable) to fulfil this function themselves they should appoint a respected proxy voting agency to carry out this function on their behalf.
Q29	Would consultees be prepared to enter debate about improved disclosure (eg of contracts for difference)?
	We welcome the willingness of HFWG members to contribute to discussions and note that the FSA has begun consultations on this very topic. We do not, however, accept that "the voluntary adoption of enhanced disclosure requirements by hedge fund managers….would cause distortions in the market place". The market distortions already exist; voluntary disclosure would reduce the distortions, albeit not eliminate them.
Q30	Would other consultees value a wider debate aiming at voting being restricted to those holding economic interest?
	This is a matter of fundamental importance and we strongly support a wider debate. The creation of synthetic votes where voting power is separated from economic interest is a matter of the greatest concern as is the effective freezing of votes which sometimes occurs when the shares backing CFD's are isolated, thus giving disproportionate power to large minority shareholders.

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