Revisions to the Hedge Fund Standards and Feedback on Consultation (CP3/2011)

1. Overview

This paper summarises the feedback received in response to Consultation Paper 3 (CP3/2011)[1] and sets out the resulting changes to the Hedge Fund Standards.[2] The last section details the process for implementing these amendments to the Standards.

CP3/2011 focused on internationalising and strengthening the Standards in the light of a number of issues that became apparent during the financial crisis.

Ensuring that the Standards were appropriate for US managers was one of the main objectives of this consultation. About two-thirds of the global hedge fund industry is based in the United States and there is a growing interest in the Standards from US managers and leading international investors. Some of these international investors are already represented on the Hedge Fund Standards Board or are members of the HFSB Investor Chapter.

The amendments to the Standards relating to fund governance, in particular, have been designed to cater for a different approach to structuring hedge funds that is typical in the US. We are proposing, for example, that where a fund does not have an independent governing body in place to protect investors' interests, there should be an obligation to ask for investor approval before key actions may be taken which may involve a potential conflict of interest between the manager and investors.

Another aspect of this consultation comprises a series of proposals to strengthen the Standards in the light of lessons learned from the financial crisis. There are a series of proposed amendments aimed at:

- strengthening disclosure to investors;
- improving risk management;
- ensuring consistency in valuation; and
- ensuring that policies are in place to prevent market abuse.

[1] http://www.hfsb.org/?page=11474

[2] The original amendments proposed in CP3 are highlighted red and revisions thereof following the consultation are highlighted yellow.

The HFSB would like to thank those who invested time and effort in responding to the Consultation Paper and offering feedback. The HFSB would also like to give special thanks to Tim West at Herbert Smith for his advice.

The remainder of this document presents the finalised amendments to the Standards and a summary of the feedback received in writing as well as during consultation meetings.

Some of the respondents suggested improvements which went beyond the scope of the specific areas covered by the consultation. While these suggestions and comments were very valuable, currently they cannot be accommodated without consulting all the stakeholders. However, the HFSB has noted them and will take them into account during future consultations on the Standards.

1. Internationalisation of the Standards

1.1. Governance (Standard 21.1, 21.2)

The HFSB has suggested that in instances where there is no independent governing body, more specific rules governing fund behaviour should be included in the fund documentation. For example, investors should have the right to approve certain key actions or should be given sufficient notice to redeem before such actions take effect. The proposed Standard therefore focuses on increasing investor confidence in governance procedures in those cases where no independent governing body is in place.

Consultation Feedback

Q 1: Do you agree that where the fund governing body is not sufficiently independent, this proposed approach would help mitigate conflicts of interest between investors and managers? If you disagree, please elaborate.

Most respondents broadly agreed, although some made additional suggestions to the proposed approach:

Additional Points Raised by respondents:	HFSB Perspective:
The proposed examples of "key actions" proposed in Standard 21.2 are too broad and inoperable. • Under the proposal, all changes that are not unambiguously beneficial would trigger a vote/redemption right. As most changes are material, this would trigger a vote/redemption right in many instances. "Material adverse changes" is most commonly used in fund agreements. • Changes to investment strategy by definition cannot be deemed as beneficial or adverse to investors until after the change has been made. • There can be situations where changes to legal structure would likely be necessary due to changes in tax law and would therefore be outside the control of the manager.	The HFSB agrees. The list of examples of "key actions" has therefore been made more specific, and a vote/right to redeem is only triggered where there are material adverse changes to fees/expenses/other economic terms or material changes to the stated investment strategy or legal structure (unless required by law or regulation).
Circumstances may exist where more flexibility is required to respond to a quickly changing market environment. In such circumstances, alternative investor notification procedures should be permitted. Specific constraints may	The proposed amendment to trigger a vote/redemption right to material adverse changes (rather than changes that are not unambiguously beneficial)

be detrimental to the efficiency of fund management services, slowing down the decision-making process to the disadvantage of clients.	enhances the flexibility while protecting investors.
Alternative approach: allowing for creation of new share classes so that the new terms apply only to new investors.	The HFSB acknowledges this is as an option but it goes slightly beyond what is covered by CP 3.
To enhance the understanding of boards, the number of board directorships mandates of individual board members should be disclosed.	The HFSB is aware of efforts to enhance transparency around board mandates. While this topic has not been consulted on as part of CP 3, it will be considered by the HFSB for future consultations.
Other suggestions include the creation of investor committees and investors having a say in the appointment process of board members.	These are not within the scope of the current consultation.
Some respondents argued that board members who are involved in relationships with the manager's group or who conduct business with the manager's group (e.g. administrator) should be deemed "non independent".	The Hedge Fund Standards deal with this aspect through disclosure: guidance to Standard 21.6 refers to full disclosure of director's potential conflicts of interest with investors through the fund's offering documents. However, the HFSB also acknowledges specific Cayman structures (see next comment).
It was highlighted that under certain Cayman partnership structures, the independent fund board is also overseeing the manager (Cayman), and where under the proposed Standard, the board would be considered not independent (i.e. par t of the manager's group).	The HFSB has acknowledged the set up of such partnership structures as independent by adding guidance to the Standard.

New Standard 21: Fund governance Standards and Guidance

21.1 Prior to the establishment of a fund, a hedge fund manager should assess where the fund governance structure will lie on the "spectrum" (see above)[3]. In the 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.

[3] Refers to introductory section of the Governance chapter – see amendments in the main document with the Standards (section D).

In determining the fund governance structure which is suitable in the case of any particular fund, the HFSB believes that managers will wish to consider:

- the range of relevant skills and experience of the fund governing body and the extent to which the fund governing body is able adequately to supervise, and hold to account, the hedge fund manager; and
- the extent to which the fund governing body is able to operate independently of the hedge fund manager.

21.2 Where a majority of the individual members of the fund governing body are not independent of the manager or where there is no fund governing body, certain key actions, such as (a) material adverse changes to: the fees and expenses payable by the fund to the manager or the redemption rights available to investors, or (b) material changes to the fund's stated investment strategy or legal structure should (unless required by law or regulation) ~~(except changes that are unambiguously beneficial to investors or their investments in the fund)~~ only be taken with investor consent (obtained in accordance with the provisions relating to investor voting/consent/approval contained in the fund's constitution) or if advance notice is provided sufficient for investors to redeem before such actions take effect.

– For the purposes of this Standard, the HFSB would not consider a member of a fund governing body to be independent if he or she is a director, employee, partner or officer of the fund's manager or of any member of the manager's group with the following exception:

The HFSB acknowledges that in certain structures an entity within a manager's group may act as the governing body to certain funds managed (e.g. as a general partner to limited partnership funds). Where an individual acts as a director of such an entity and, but for this, would be considered independent of the manager, then such an individual may still be viewed as independent for the purposes of this Standard.

…

1.2 Removing explicit anchoring in the FSA principles

The Hedge Fund Standards Board has proposed that any specific reference to the FSA Principles in the Standards should be deleted in the light of the growing international base of signatories and investors and in order to avoid the Standards being tied to a particular national regulatory regime.

Consultation Feedback

Q 2: Are there any objections to deleting references to the FSA's Principles for Businesses from the text of the Standards?

Most respondents agreed with this. Some respondents suggested that it would make sense to retain some general principles for hedge fund managers, and the principles could be retained without

referring to the FSA. One respondent suggested that the principles are helpful for UK-based managers.

The HFSB has decided to remove the explicit reference to the FSA principles.

1.3 Review of legal wording

When the Standards were initially drafted, wording was introduced to clarify that in certain areas compliance with a particular Standard would require action on the part of the relevant fund governing body, rather than its manager. In such instances, each Standard provided that in order to comply, the manager was required “to do what it reasonably can to enable and encourage the fund governing body” to achieve the particular outcome required by the Standard.

The HFSB has proposed that the wording of each relevant Standard should be put in the passive voice, stating the desired outcome to be achieved rather than stating what action the manager and/or fund governing body is required to take, to achieve the outcome.

Approach (example):

Original wording: 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.**

Proposed new wording: **Valuation arrangements aimed at addressing and mitigating conflicts of interest in relation to asset valuation** should be put in place**.**

In order to clarify the distinction between the manager and the fund governing body, the HFSB has proposed to include the following explanation in the introduction to the Standards:

"The HFSB recognises that the power to ensure compliance with certain of the Standards rests with the fund or its governing body, rather than with the manager. For example, the requirement in Standard [5]: "to ensure that the fund puts in place valuation arrangements aimed at addressing and mitigating conflicts of interest in relation to asset valuation" requires action by the fund governing body and is outside the control of the manager. In such circumstances, the relevant standard should be read as requiring the manager-signatory to do what it reasonably can to enable and encourage the fund governing body to ensure compliance with the relevant Standard. **If despite the manager’s effort the governing body declines to comply, the manager should explain this in the Disclosure Statement."**

The Standards would therefore explicitly require the manager to explain those areas where the manager has encouraged the fund governing body to comply with the relevant Standard but, despite the manager’s efforts, the required outcome has not been achieved.

Consultation feedback

Q3: Do you agree with the proposed approach to remove the wording referred to above from the text of individual Standards and to replace it with the above explanatory wording in the introduction to the Standards? If not, why?

Most respondents agreed with the approach. Some of the issues raised include:

Additional Points Raised by respondents:	HFSB Perspective:
The proposed approach removes clarity as to who is in charge.	Reference to the explanatory section in the introduction will be introduced via a reference (footnote) in the respective Standard.

Q4: Is it appropriate to require explicit explanations in those areas where, despite the manager's efforts, the desired outcome is not achieved?

Many respondents agreed, but some issues have been raised:

Additional Points Raised by respondents:	HFSB Perspective:
Some respondents do not consider it appropriate to include such explanations in the disclosure statements and that it is not appropriate to hold the fund manager accountable for the decisions of the fund board, given that the two are intentionally separate.	From an investor perspective, it is the outcome that matters (e.g. does the fund governing body receive regular reports from the fund's administrator in Standard 21) and not so much whether the manager has merely encouraged the fund governing body (without achieving the desired outcome). While the HFSB agrees that the fund governing body has ultimate responsibility for certain actions referred to in the Standards, it considers that the manager will still have a key role to play in the implementation of the Standards. This should not detract from the fund governing body's independent decision-making power. Therefore, the manager is well positioned to disclose instances where the desired outcome is not achieved in the Disclosure Statement. However, as suggested by one respondent, the manager can specify those areas where it believes it cannot control whether the Standard is adhered to or not in the form of an explanation in the Disclosure Statement.

One respondent has suggested that the fund governing body should provide the explanation, not the manager.	There is no dedicated disclosure mechanism for fund governing bodies and the HFSB regime relies on the Disclosure Statement by the manager for all relevant disclosures. In line with the assessment above, the HFSB believes that the manager is best positioned to compile the explanations in the Disclosure Statement (which can include an explanation where it believes it cannot control whether the Standard is adhered to or not in the form of an explanation).
For managers with a large number of fund products, the disclosure statement is not the ideal mechanism for disclosure since an explanation might only apply to a subset of the manager's fund products.	The HFSB acknowledges that there can be situations where an explanation relates to a single fund product out of many. As indicated in the introduction to the Standards, a manager can indicate in the Disclosure Statement any area to which the Standards do not apply. Also, for the avoidance of doubt, a manager can indicate in its Disclosure Statement if an explanation relates to a subset of funds.

The amendment proposed in CP3 will be implemented as initially suggested: the explanatory language will be included in the introduction to the Standards, and the amendments will affect the following Standards:

- Investment Policy and Risk Disclosure: 1.1, 1.3, 1.4
- Commercial Terms Disclosure: 2.1, 2.2, 2.5, 2.6
- Performance measurement: 3.1
- Valuation: 5.1, 5.2, 6.1, 6.2, 7.1, 7.2, 8.3, 8.4
- Risk: 9.1 (only reference to fund governing body), 10.1, 11.2, 16.1, 17a.1, 17a.4, 17a.5, 17a.6, 17c.2, 19.2, 19.3, 19.4, 19.6, 19.7
- Fund Governance: 21.3, 21.4, 21.7, 22.1, 22.2

2. Strengthening Investor Disclosure

2.1. Investment policy and risk disclosure

The HFSB has proposed a series of amendments in relation to investment policy and risk disclosure:

- The amendments to **Standard 1.1** seek to enhance general ex ante disclosure to investors.
- The amendments to **Standard 1.3** seek to clarify that material changes to the fund's investment policy require either investor consent (in accordance with the provisions relating to shareholder voting/consent/approvals in the fund's constitution) or the provision of sufficient notice to enable investors to redeem prior to the effective date of the changes.
- The amendment to **Standard 1.5** seeks to establish ongoing reporting in relation to investment strategy, risk profile, and the manager's business.
- The amendment to **Standard 1.6** seeks to ensure that investors are informed about material litigation against the manager.

Consultation Feedback: Standard 1.1 (investment policy/risk disclosure)

Q5: Do you agree with the proposed improvements on disclosure in Standard 1.1 (investment policy/risk disclosures)? If not, please explain.

Most respondents agree with the overall approach, however, specific aspects have been raised as part of the consultation:

Additional Points Raised by respondents:	HFSB Perspective:
It was highlighted that "process" is subject to change and that the offering documents might not be a suitable mechanism for disclosure, and should rather be included in the marketing materials. Some respondents indicated that it is not sufficiently clear what the reference to "process, guidelines" meant. Also, many respondents highlighted that the inclusion of guidelines in the offering document might imply that those guidelines are legally binding.	1. The HFSB agrees that some of the disclosures such as "process" are better catered for in other disclosure documents such as marketing materials. 2. It has been clarified that "process" refers to "investment process" 3. The term guidelines has been removed.
There are regulatory restrictions around the disclosure of target returns for US managers.	The clause "to the extent permitted by applicable law and regulation" has been added.
The approach to leverage should be consistent with the requirements in the Alternative Investment Fund Managers (AIFM) Directive.	The HFSB will review the Standards in light of the various regulatory initiatives (including the AIFM-Directive) in the near future.

More generally, the offering document should contain a dedicated risk section in line with CFTC requirements.	

New Standard 1.1 (Investment policy/risk disclosure)

1.1 ~~A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to include a~~ 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~~, process, guidelines~~ and associated risks should be included in the fund's offering documents.[4]

The HFSB envisages that in most circumstances such disclosure would include, amongst other things:

- 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;
- ~~details of the investment process, including internal reviews and controls; and~~
- an explanation of the circumstances in which the fund may use leverage, the sources of such leverage, ~~and~~ details of any restrictions on the use of leverage~~,~~ and, where applicable, an explanation of how the manager defines leverage and/or net exposure levels.

Additional disclosure (not necessarily in the offering documents) might include:

- to the extent permitted by applicable law and regulation, the target return for the strategy, if applicable;
- the target level of risk for the strategy;
- to the extent permitted by applicable law and regulation, the historical track record of the strategy, if applicable;
- details of the investment process, including internal reviews and controls;
- upon request, the aggregate value of assets managed by the manager using the same investment strategy; and
- ~~the manager's "soft-dollar" policy or "use of dealing commissions" policy and practices.~~

…

[4] See introduction, chapter 1.3 of the actual Hedge Fund Standards: The fund versus the manager

The proposed guidance in relation to *"soft-dollar" policy or "use of dealing commissions" policy and practices* has been moved to the disclosure section in the operational risk section (Standard 18) as per below:

> **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.**
>
> Additional disclosure might include:
>
> – the manager's "soft-dollar" policy or "use of dealing commissions" policy and practices.

Consultation Feedback: Standard 1.3 (changes to the investment policy)

> **Q6:** Do you agree with the approach for investor involvement in the context of material changes to the investment policy (1.3)? If not, please explain.
> **Q7:** The Standard refers to the provisions relating to shareholder voting/consent/approvals contained in the fund's constitution: Is it necessary to specify these provisions in more detail (1.3)?

Many respondents agree with the proposed approach and that there is no need to specify shareholder voting/consent/approvals further. Other issues have been raised:

Additional Points Raised by respondents:	HFSB Perspective:
Question 6:	
Matters in relation to the investment policy are better dealt with through disclosure. Rationale: Meaning of investment policy is very broad. Example: A multi strategy mandate may invest in any instruments that the manager deems appropriate. Despite its broad mandate, the fund has never invested in a particular asset class (e.g. emerging markets) over its ten year history. If the manager decides to start investing in this particular asset class, this will require a vote.	The HFSB agrees that disclosure is in any case an important element in ensuring investor expectations are aligned with the strategy of the fund. If the investment policy is deliberately kept very broad to enable the manager to pursue many different strategies within the mandate, the HFSB would not expect the manager to obtain investor consent or provide advance notice sufficient for investors to redeem in situations where changes in the fund's investment approach are within the parameters of the investment policy.
If an offering document/fund constitution for a specific fund is deliberately structured in a	The HFSB agrees with this observation.

manner which allows investment policies to be changed without investor consent/advance notice (and the investor has agreed to this), the Standard would require an explanation by the manager to all investors (even those not investing in the specific fund) stating that such material changes are eligible in the context of this fund.	
Obtaining consent from hundreds of investors might be difficult. It is the responsibility of the investment manager and the fund directors to consider the investors' best interests in accordance with applicable law/regulation and if investors disagree, with changes to the investment policy, they can opt to redeem.	The HFSB acknowledges that there are situations where investor consent cannot be easily obtained and agrees that in such situations, allowing investors to redeem prior to the change in investment policy taking effect might be a more suitable approach.
Question 7:	
• Does consent mean 51%, 75% or 100% approval? • Who collects this consent information? • How are those not consenting being considered?	The HFSB neither prescribes a definition for consent (i.e. 51%, 75% …) nor offers details about the mechanism/process for obtaining consent. This is to be specified in the fund's constitution.

New Standard 1.3 (changes to the investment policy)

1.3 ~~A hedge fund manager should consider carefully 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 mechanismappropriately in the fund's offering documents.~~ No change to the fund's investment policy/strategy which the fund governing body considers to be material should become effective without either (a) obtaining investor consent in accordance with the provisions relating to investor voting/consent/approvals contained in the fund's constitution/offering document, or (b) providing advance notice sufficient for investors to redeem without penalty prior to the effective date of the changes.

Consultation Feedback Standard 1.5 (material developments)

Q8: Do you agree with the addition of Standard 1.5 (periodic disclosure on material developments)? If not, please elaborate.

Most respondents agree that there needs to be a mechanism for disclosure of periodic changes, but some issues have been highlighted:

Additional Points Raised by respondents:	HFSB Perspective:
Only staff changes (i.e. involving senior management) should be material to warrant discussion in periodic reports.	The HFSB agrees, and has included the term "key" before "staff changes".
Remove "process" from "changes in investment strategy or process" (since investment processes are subject to change and it is not value added to disclose changes).	The HFSB acknowledges that the investment process is subject to change. For this reason, disclosure has been removed from the offering documents and included in "other disclosures" (such as marketing materials) in Standard 1.1 since it is appropriate to inform investors about changes to the investment process from time to time.
There has been a spectrum of views in relation to frequency of disclosure: • Disclosure should not be a formalised process which occurs within a specific timeframe. Sometimes, ad hoc is more appropriate (as and when issues occur). • Wording such as "Generally monthly or quarterly" should be more specific. Language such as "no less than quarterly" would provide stronger guidance to the hedge fund and further protect investors.	The HFSB leaves it to the manager to determine the appropriate frequency of disclosure and where ad hoc notifications might be suitable.
Some respondents suggested that managers should have annual re-issuance of relevant marketing documents.	The HFSB acknowledges that over longer periods where a number of changes might have occurred to the investment process, updated marketing/due diligence documents are useful. However, this introduces a new aspect to this particular Standard, and inclusion of this aspect would require further consultation and might be considered in future consultations on improvements to the Standards.

New Standard 1.5 (material developments)

1.5 A hedge fund manager should make periodic disclosures (generally monthly or quarterly) regarding material developments in the investment strategy, the manager's business and the fund's risk profile.

The HFSB envisages that such disclosure would, amongst other things, include (in each case to the extent material and relevant to investors in the fund):

- changes in investment strategy or process (past and anticipated); and
- items in relation to the manager's business or the fund, such as key staff changes, new or terminated funds, or changes to any key service providers.

Consultation Feedback: Standard 1.6 (material litigation)

Q9: Do you agree with the addition of Standard 1.6 (disclosure of material litigation and formal regulatory proceedings)? If not, please elaborate.

Respondents broadly agreed with the chosen overall approach: the following aspects have been highlighted:

Additional Points Raised by respondents:	HFSB Perspective:
Many respondents highlighted that a materiality threshold should be introduced since there is no need to disclose immaterial litigation with no impact.	The HFSB agrees and has therefore included the term material has been added before "litigation" and "formal regulatory enforcement proceedings". Further guidance has been added that "for the purposes of this Standard, proceedings which the manager considers to have been brought frivolously or vexatiously are not considered to be material litigation".
The CFTC requires disclosure of any material administrative, civil or criminal action, whether pending or concluded against the manager, any principal, or its broker (…). The SEC's Form ADV (public document) requires similar disclosures with respect to registered investment advisors.	The HFSB agrees that it is appropriate and common practice in many areas of financial services to provide this type of disclosure.
One respondent highlighted concerns about reputational risk for managers and that there seems little advantage to investors if investigations are announced before any conclusion have been drawn by the relevant regulator. Certain debt strategies might involve suing (and getting sued) – concern about whether this should be disclosed	From an investor perspective, it is of relevance if material litigation is brought against a manager since it might draw upon manager resources, or otherwise flag issues that investors wish to be aware of.

Does the Standard seek to provide detail or just inform about the existence of litigation/ enforcement?	It is difficult to specify the appropriate level of disclosure. Therefore, the HFSB leaves it to the manager to determine the appropriate level of disclosure. Of course, disclosing simply that the manager is involved in material litigation or a formal regulatory enforcement proceeding may lead to requests by investors for further detail.

New Standard 1.6 (material litigation)

1.6 Upon reasonable request, a manager should (unless, and to the extent that, the manager is restricted from doing so pursuant to applicable law or regulation, is instructed not to do so by any governmental or regulatory body, or is restricted from doing so under confidentiality obligations owed to a third party) disclose to investors (a) any material litigation in which it is involved ~~(other than proceedings which the manager considers to have been brought frivolously or vexatiously)~~ and (b) any material formal regulatory enforcement proceedings against it.

- For these purposes, the HFSB considers by way of example, that in the U.K., the appointment of "specific" investigators under section 168 of FSMA, or the appointment of investigators to assist overseas regulators under section 169 of FSMA; and in the U.S., commencement of a formal inquiry by the Enforcement Division of the SEC or any action which would be required to be disclosed under Item 11 of SEC Form ADV (Part 1A) or CFTC Rules 4.34(k)(1) or 4.24(l)(1) (or the equivalents in jurisdictions outside the UK or US, as appropriate) would constitute "formal" regulatory enforcement proceedings.
- The HFSB considers that the appointment of "general" investigators under section 167 of FSMA or a request for information as part of a thematic review or otherwise pursuant to sections 165 or 165A of FSMA or a notice requiring the provisions of a report under section 166 of FSMA (or the equivalents in jurisdictions outside the UK) would not constitute "formal" regulatory enforcement proceedings.
- The HFSB considers that a routine examination of a US investment adviser under section 204 of the Investment Advisers Act, or the inclusion of an investment adviser in an SEC sweep exam, would not constitute "formal" regulatory enforcement proceedings.
- For the purposes of this Standard, proceedings which the manager considers to have been brought frivolously or vexatiously are not considered to be material litigation.

2.2. Commercial terms disclosure

The proposed amendments in CP3 focussed on improved disclosure of fees and expenses, handling of changes to commercial terms, and fair treatment of investors in relation to parallel funds and accounts.

Consultation Feedback: Standard 2.1, 2.5 (fees/expenses/redemption rights)

Q10: Do you agree with the proposed amendments in relation to disclosure of fees and expenses (2.1 and 2.5)? If not, please elaborate.

Both agreement and disagreement, with the following issues highlighted:

Additional Points Raised by respondents:	HFSB Perspective:
In Standard 2.5, "Financial statements" should be replaced with "audited financial statements" to clarify that the standard refers to the annual published accounts and not any other financial disclosure a manager might make.	The HFSB agrees and the proposed amendments have been adopted.
The term "commercial terms" is very broadly used.	The term "commercial terms" has been used in the Standards since inception. The guidance to the relevant Standard 2.1. specifies the types of disclosure that this would include.
Please clarify if the term "material" should apply to 2.5? (if yes, agreement)	The fund's audited financial statements should include all fees and expenses.
It is impracticable to disclose more than the methodology for calculating fees (such as the Prime Broker's fee) or to disclose more than the nature of the expenses that may be incurred but not the amount in any particular financial year.	The existing guidance refers to the "method of calculation" of the periodic fees payable to the fund's service providers.
What sorts of items are included in "other material fees, costs and charges"? E.g. legal fees, brokerage fees, registered office fees? Would disclosure include the amount of the fee, or just the fact that such a fee may be incurred?	Disclosure would include that such fees may be incurred. It will not be possible, for example, to specify in advance the legal fees which may be incurred. The amendment to the Standard such that it now requires a "description" of such fees clarifies this.

New Standards 2.1 and 2.5 (fees/expenses/redemption rights)

2.1 ~~**A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to disclose the**~~ **The commercial terms applicable to the relevant interests being offered in a particular hedge fund should be disclosed in the fund's offering documents in sufficient detail and with sufficient prominence (taking into account the identity and sophistication of potential investors)** ~~**in the fund's offering documents**~~**.**[5]

The 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;

[5] See introduction, chapter 1.3 of the actual Hedge Fund Standards: The fund versus the manager

- details of any other remuneration received by the manager in connection with its management of the fund (this will be relevant, for example, where a hedge fund is a "feeder" fund into another fund managed by the same manager);
- the basis of calculation for any base management fee and details of 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;
- to the extent known, ~~details~~ a description of other material fees, costs and charges which will be payable by the fund; and,
- if applicable, the fact that the fees and expenses payable to service providers may change.

…

2.5 ~~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~~ The fees and expenses (including but not limited to management and performance fees) charged to the fund should be disclosed in the fund's audited financial statements. This includes explanations in the annual report which allow investors to compare, readily, the fees and expenses charged with the description of such fees and expenses set out in the fund's offering documents where this is not obvious from the disclosure in the financial statements.[6]

For example, the categories and captions in the fund's financial statements might correspond to those used in the fund's offering documents so that 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.

Consultation Feedback: Standard 2.2 (changes to commercial terms)

Q11: Do you agree with the mechanism to introduce changes to commercial terms (i.e. investor consent or prior ability to redeem)? If not, please elaborate.

Both agreement and disagreement, key concerns:

Additional Points Raised by respondents:	HFSB Perspective:
Disagreement, unless it relates specifically to investment management fees. If it applied to brokerage fees (such as executing broker or clearing broker fees), the concern has been raised that these fees may be increased unilaterally by such brokers and there would not be sufficient	It has been clarified that this relates to fees payable to the manager (or parties related to the manager).

[6] See introduction, chapter 1.3 of the actual Hedge Fund Standards: The fund versus the manager

time to obtain consent or give advance notice to investors.	
Without a definition of what constitutes materially adverse to investors, respondent cannot agree: proposal will have heavy operational and investment constraints on its practical application as there is no obvious "one size fits all" solution for investors. As indicated, investors have the ability to participate in the governance of the fund via voting rights prescribed by the fund's constitution. (BR)	It has been clarified that this relates to fees payable to the manager (or parties related to the manager).

New Standard 2.2 (changes to commercial terms)

2.2 ~~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~~ Changes to the fees and expenses payable by the fund to the manager or parties related to the manager ~~or other economic terms~~, or the redemption rights available to investors ~~such commercial terms that~~ which **the fund governing body considers to be materially adverse to investors should not be effected without either (a) obtaining investor consent in accordance with the provisions relating to shareholder voting/consent/approvals contained in the fund's constitution, or (b) providing advance notice sufficient for investors to redeem prior to the effective date of the changes without penalty.**

Consultation Feedback: Standard 2.4 (Parallel funds/accounts)

Q12: Do you agree that the existence of parallel funds/accounts should be disclosed in order for investors to be able to assess the impact of such parallel funds/accounts on their investments in the fund? If not, please elaborate.

Both agreement and disagreement, key concerns raised:

Additional Points Raised by respondents:	**HFSB Perspective:**
There are concerns that the Standard might require disclosure of confidential information, or may restrict (manager's or investor's ability?) ability to agree terms which are different from managed account to managed account.	The Standard does not require the disclosure of confidential information. **Guidance has been added to clarify that no disclosure of specific details of such funds or accounts is required.** This Standard is to be seen in conjunction with the guidance to Standard 1.1 (disclosure of the aggregate value of assets under management using the same investment strategy).

A key disclosure should be made around differential liquidity of managed accounts vis-à-vis fund investments.	Where differential liquidity of for example managed accounts vis-à-vis funds has a detrimental effect on the investors in the fund, this should be disclosed.

Q13: Is it necessary to specify the mechanism for disclosing the existence of parallel funds/accounts (if yes, please specify how disclosures should be made)?

Most respondents felt there was no need to specify a mechanism for disclosure. Some provided examples of a disclosure template or as part or suggested disclosure as part of the GIPS composite table.

New Standard 2.4 (parallel funds/accounts)

2.4 Upon request, a hedge fund manager should disclose (a) the existence of any other funds or accounts managed by it using the same strategy with which it manages the fund and (b) any material adverse effects which the existence of such other funds or accounts may have on investors in the fund.

For the avoidance of doubt, the Standard requires hedge fund managers to disclose that they manage other funds or accounts, but does not require disclosure of specific details of such funds or accounts.

2.3 Policies to prevent market abuse

The HFSB had proposed that an unregulated manager should make a summary of its prevention of market abuse policy available to investors upon request.

Consultation Feedback: Standard 24.1 (prevention of market abuse)

Q14: Do you agree with the proposed amendment? If not, please elaborate.

Most respondents agreed with the proposed amendment. The following issues have been raised by respondents:

Additional Points Raised by respondents:	HFSB Perspective:
Rather than requiring disclosure of the existence of the policy to prevent market abuse, it was suggested that the desired outcome should just be stated: a manager should have a policy to prevent market abuse, and unregulated managers should make a summary thereof available to	The HFSB agrees and has amended the Standard accordingly.

investors upon request.	

New Standard 24.1: Prevention of market abuse

24.1 A hedge fund manager shall have a policy to prevent market abuse ~~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)~~. For managers that are not regulated, a summary of the policy should be made available to investors upon request.

3. Consistency in Valuation Disclosure

The HFSB has proposed the use of accounting definitions (e.g. ASC820 or IFRS 7) in order to classify hedge fund assets. The purpose of the amendment is to enable better understanding by investors of valuations and the characteristics of the fund's portfolio.

Consultation feedback: Standard 8.1, 8.2 (valuation disclosure)

Q15: Do you agree with the objectives of improving investor understanding of asset valuations and consistency of valuation reporting?

Q16: Is it appropriate to use definitions included in accounting principles/standards in the context of valuations? If not, please elaborate.

Q17: Do you agree that the fair value hierarchy helps investors assess the characteristics of the assets in the fund? If not, please elaborate.

Q18: Do you agree with the proposed amendments? If not, please elaborate.

Most respondents agreed with the objective of improving investor understanding of asset valuations and consistency of valuation reporting and agreed that the fair value hierarchy helps investors to assess the characteristics of the assets in the fund.

There was also broad agreement that it is useful to draw upon internationally understood and generally accepted definitions for the classification of assets. However, the following points were raised by respondents:

Additional Points Raised by respondents:	HFSB Perspective:
It is inappropriate not only to use definitions included in accounting principles/standards in the context of valuations, but also to make any reference thereto at all. The valuation of hedge fund assets is governed by the Fund's constitution and/or offering documents and not by accounting principles/standards which seek to achieve different objectives.	Standard 8.1 does not require that valuations are governed by accounting principles, but that the portfolio composition is disclosed according to well established definitions (L1/2/3 assets). Thereby, the actual valuation of the hedge fund assets (according to the valuation policy) is not affected.
Use passive voice in 8.1: "The percentage of the fund's portfolio that falls into each of the three	The HFSB agrees, and has made the relevant amendment.

"levels" prescribed by ASC 820 or IFRS 7 … should be periodically disclosed. (Rationale: administrator might be in charge)	
A minimum frequency of disclosure should be specified.	The HFSB is currently not prescribing a disclosure frequency.
One respondent suggested that the manager should use third party valuation agents to validate their own valuations of a subset or all of the Level 3 assets.	The proposed amendment to the Standard 8.1 deals with the standardisation of Disclosures in relation to valuations. Issues in relation to segregation of functions in valuation are dealt with in Standards 5.1 and 5.2. At present, in the existing guidance to Standard 5.1, the HFSB makes clear that the appointment of an independent and competent third party is considered the most satisfactory way to mitigate conflicts of interest in valuations.

New Standard 7 (Hard-to-value assets – Governance Standards and Guidance)

7.1 Where a hedge fund manager performs in-house valuations of ~~what it considers to be~~ hard-to-value assets ~~(i.e., Level III assets as defined by ASC 820[7] or IFRS 7)~~ ~~in-house~~[8] 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 should be adopted and ~~ensure that~~ such procedures ~~are~~ should be set out in the Valuation Policy Document. [9]

…

Proposed amendments - Standard 8: Hard-to-value assets – Disclosure Standards and Guidance

8.1 ~~A hedge fund manager should disclose periodically t~~The percentage of the fund's portfolio that falls into each of the three "levels" prescribed by ASC 820[10], IFRS 7, or equivalent accounting standards or recognised definitions (and, where meaningful and applicable, the extent to which internal pricing models or assumptions are used to value certain components

[9] See introduction, chapter 1.3 of the actual Hedge Fund Standards: The fund versus the manager

[10] Formerly FAS 157

of the fund's portfolio invested in hard-to-value assets) ~~is invested in what the manager considers to be hard to value assets~~ should be periodically disclosed (e.g. via newsletters).

~~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).~~

8.2 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.

4. Strengthening Risk Management

The amendments in the area of risk management focus on preventing the misappropriation of client monies, strengthening the approach to personal account dealing and improving oversight of fund administration.

4.1. Operational risk- strengthening fraud prevention

Q19: Do you agree with the proposed amendment? If not, please elaborate.

Broad agreement, some suggestions:

Additional Points Raised by respondents:	HFSB Perspective:
The responsibility of non-securities related cash movements should reside with a third party, i.e., an independent administrator. An explicit disclosure requirement should be added for instances where client money is held by the manager.	The HFSB agrees that conflicts in such situations are best mitigated by appointing an independent administrator. Standard 17a.4 refers to the appointment of an independent administrator (including in relation to the calculation of the NAV and the maintenance of the accounting records of the fund). There is at present no explicit mention that non-securities related cash movements should reside with a third party. The HFSB will consider this amendment in the context of a review of the current Standards in relation to fund administration.

Proposed amendment Standard 17c: Fraud and financial crime prevention

17c.1 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~~ the hedge fund manager might be used to further financial crimes.

This may apply to areas such as:

- anti-money laundering procedures[11] (although typically the fund's administrator will be responsible for compliance); and
- 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.~~

…

[11] 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).

17c.3 Where client money is held by the manager, the manager should put in place strict internal controls to prevent misappropriation of such money (e.g. co-signing policies).

4.2. Operational risk - personal dealing

A new standard on personal dealing is proposed which requires disclosure to investors of a summary of the personal dealing policy where a manager is not regulated. The reference to personal account dealing in Standard 17a.3 has been deleted.

Q20: Do you agree with the proposed amendment? If not, please elaborate.

Agreement, but a few points/questions highlighted:

Additional Points Raised by respondents:	HFSB Perspective:
Some respondents asked for more guidance in relation to the "testing of compliance" in the context of personal accounting dealing	The HFSB has included an example in the Standard as to what could constitute "testing of compliance".

New Standard 17h (Operational risk – personal account dealing)

17h.1 A hedge fund manager should adopt a personal account dealing policy for its staff, ensure awareness of this policy, test compliance from time to time (e.g. comparing broker statements against trades for which permission has been granted) and, where a manager is not regulated, make a summary of the policy available to investors upon request.

4.3 Outsourcing risk

The proposed amendments seek to improve supervision of fund administration by the manager. The Hedge Fund Standards now explicitly mention monitoring and reporting of issues in relation to the quality of such services to the fund governing body in Standard 19.

Q21: Do you agree with the proposed amendment? If not, please elaborate.

There was broad agreement with the approach. Some suggested that a materiality threshold should be included so that "any material concern" is reported to the fund governing body.

New Standard 19 (Outsourcing risk - Governance Standards and Guidance)

Valuation and administration

…

19.4 ~~A hedge fund managers should do what it reasonably can to enable and encourage the fund governing body to review~~ The services provided by the relevant service provider should be reviewed and monitored against contractual or other agreed standards. [12]

19.5 The manager should report to the fund governing body any material concerns it may have in relation to the quality of such services.

…

[12] See introduction, chapter 1.3 of the actual Hedge Fund Standards: The fund versus the manager

5. Process for incorporating these Standards

The existing HFSB signatories will need to revisit their approach to conformity with the new Standards and potentially adapt their Disclosure Statements to accommodate the amendments, if relevant and appropriate. To allow signatories time to carry out this exercise, the amendments to the Standards set out in this document will become effective on 01 September 2012.