Response to ASIC's CP 174: Hedge Funds, improving disclosure – Further consultation[1]

1. Introduction

The HFSB welcomes the opportunity to respond to ASIC's Consultation Paper 174 on Hedge Funds: Improving disclosure - Further consultation.

The Hedge Fund Standards Board (HFSB) is the guardian of the Standards drawn up by international investors and hedge fund managers to create a framework of discipline for the hedge fund industry. The HFSB's mission is to promote the Standards through collaboration with managers, investors and the regulatory community.

The HFSB actively engages with the regulatory community and has responded in the past to consultations on issues in relation to hedge fund regulation, including recent consultations from ESMA, IOSCO and others.

The HFSB is pleased to continue to inform the regulatory process and help ASIC's development of disclosure policies for hedge funds.

2. General observations

The HFSB is pleased to see that the approach chosen by ASIC makes uses of many of the techniques employed by the HFSB, including reliance on disclosure and transparency to enable better investment decisions, as well as the "if not, why not" ("comply or explain") mechanism. Also, many of the areas covered in the Disclosure section of the Hedge Fund Standards are reflected in ASIC's approach.

2.1. Institutional versus retail

ASIC has clarified that the consultation paper should not be regarded as an indication that it considers hedge funds to be suitable for all or most retail investors. In this context, it is important to highlight that the Hedge Fund Standards cater for the institutional market place, where market participants have or can acquire the relevant skills required to invest in hedge funds. The Hedge Fund Standards are not intended to cater for retail investors, where more investor protection is needed. However, this does not imply that many of the disclosure and governance requirements set

[1] ASIC CP 174: www.asic.gov.au

out in the Hedge Fund Standards could not be applied in the retail market context, for example, to complement and strengthen a regulatory framework for retail hedge funds.

Therefore, this response from the HFSB seeks to provide input on the necessary disclosure and governance requirements from an institutional perspective.

2.2. Meeting public policy objectives

In financial services, legislation is generally drawn up to address public policy objectives. These generally include systemic issues, protection of investors or customers and issues relating to market integrity. However, it has long been recognised that relying on legislation alone is not always effective, as the legislative process takes time, relying on courts to address issues of compliance and sanction is equally time consuming. Consequently, systems of regulation have been created that are more flexible and encourage behaviours through a combination of regulatory direction, intervention and sanction. Systems of regulation include various techniques to achieve public policy objectives embodied in the legislation which addresses specific areas of business, firms, or markets.

These techniques include three levels of granularity: Principles, Standards and Rules. For each of them, public authorities may choose different mechanisms to ensure compliance depending on how they view the effectiveness of each alternative.

- **Principles** are normally expressed at a high level and are likely to be embodied directly or indirectly in the legislation itself. A good example is the set of principles which govern the behaviour of firms regulated by the Financial Services Authority in the UK. They are widely regarded as a satisfactory articulation of the behaviours that the legislation is designed to achieve.

- **Rules** are at the other end of the spectrum. These are designed to state the precise manner in which firms are expected to conduct themselves and failure to do so will lead to sanction or intervention by supervisors or eventually the courts. By their nature, rules need to be precisely defined in order to create legal certainty. They may be amended as circumstances change but because rules need to be both precise and relevant to the intended outputs, they tend to be lengthy and can take time to change in response to the changing environment, also due to the requirement to run long and often iterative consultations. Consequently, rules work best where there is a limited need for change and where clarity can be achieved without exceptions or complex details. A good example is authorisation of firms.

- **Standards** are typically less granular than rules, but generally set out the principals of behaviour required in greater detail than can be achieved in the legislation or the principles themselves. They are specific to particular areas of business such as Hedge Funds or to an area where detailed rules themselves are impossible to draw up in a meaningful way like Governance. Standards are an appropriate way to express required behaviours in fast moving areas of business and to ensure that such principles of behaviour keep pace with the development of that business. They can allow for exceptions whilst still aiming at the same behavioural outcome intended by the legislation and the principles. The alternative would be for overly detailed rules in order to accommodate exceptions etc. But this can lead to complexity, rigidity and to parties circumventing the spirit of the rules by adapting new definitions, technical business models or escaping to jurisdictions where the rules do not apply.

The Hedge Fund Standards set levels of quality in behaviour and working practice which complement the public policy framework for the hedge fund sector. In particular, in areas of complex, diverse or more innovative practice, they allow to more efficiently achieve regulatory objectives than detailed and rigid rules.

The process put in place by the HFSB relies on both investors and regulators to endorse and drive adoption of the Standards. The HFSB process has been designed to reflect the global nature of the industry and the fact that policymakers recognise the need for a global approach to hedge fund regulation.

Since its launch in 2008, the Hedge Fund Standards have been amended three times, to address emerging issues, including strengthening of independent administration, handling of redemptions and situations of liquidity distress, enhancing fund governance, and internationalisation of the Standards.[2] The process of amending the Hedge Fund Standards involves a rigorous public consultation process involving investors, managers and regulators. This demonstrates the adaptive nature of the HFSB's approach and its ability to reflect emerging thinking at a global level on good industry practice. Most importantly, it is backed by investors, who are a powerful economic agent globally to foster better practices throughout the industry.

The HFSB framework, which includes standards, public consultations, as well as investor involvement, helps to achieve public policy objectives in an efficient manner in an area of complex, diverse and innovative practice.

The HFSB would like to encourage ASIC to look at more formal ways of embracing or making use of the Hedge Fund Standards as a meaningful complement to its own regulatory approach.

[2] See consultation section at www.hfsb.org (-> Standards -> Consultations)

3. Consultation responses

Scope of disclosure guidance (B1, B2)

B1Q1 Do you agree with the proposed scope of our disclosure guidance?

ASIC's proposed factors to determine whether an investment scheme is a hedge fund is in line with the defining features of hedge funds set out in the HFWG Final Report published in January 2008, which has been included below: [3]

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

The HFSB has not formalised the definition of hedge funds any further.

B1Q2 Should the disclosure guidance apply to any fund that manifests one or more of the characteristics identified in B1(b), irrespective of whether it is promoted or generally regarded as a hedge fund?

The HFSB has not set out a more prescriptive approach to identifying hedge funds.

B1Q3 Should the test at B1(a) of whether a fund is a hedge fund be simply another characteristic to be considered in deciding whether a fund is a hedge fund?

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B1Q4 Should the disclosure guidance apply to funds that only manifest one of the characteristics identified in B1(b), or should some features (e.g. use of leverage) be more decisive than others in the characterisation of hedge funds?

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B1Q5 Does our proposed approach provide a sufficient level of certainty? If not, how should 'hedge fund' be defined, and why?

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[3] See http://www.hfsb.org/sites/10188/files/final_report.pdf , based on a definition in Oliver Wyman: Perspectives on Asset Management – Hedge Funds, growth sector or maturing industry? (2005).

This highlights the complexities in drawing a clear line in an area, where there is a "continuum" of approaches and continuous innovation (also see section 2.2, Meeting public policy objectives). Hedge funds have pioneered many investment techniques in the last decades, and many of these techniques (e.g. use of derivatives for hedging purposes) are now commonly used in the "long only space". A very wide definition of hedge funds can imply that many traditional funds would be considered as hedge funds, but a prescriptive narrow definition (e.g. all factors set out in the consultation paper have to be met) may not embrace all "hedge funds" or what will be considered to be a hedge fund over time.

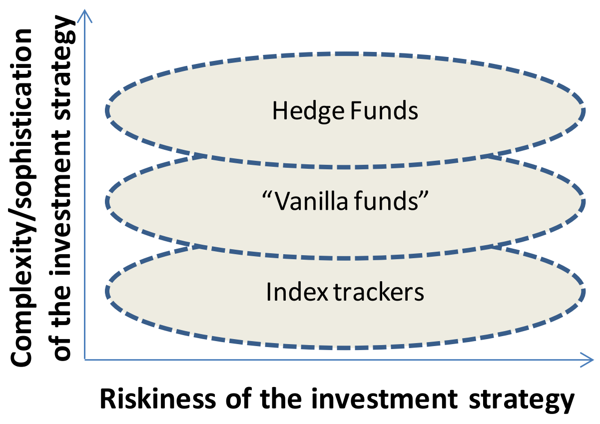
One way to proceed is to define a number of sufficient conditions (e.g. use of short selling, or leverage) to classify a fund as a hedge fund, but also maintain a number of qualitative criteria (e.g. complexity of investment strategy) to assess this. An alternative approach could be to define what is NOT a hedge fund (e.g. long only fund, not using leverage etc).

However, it is important that the chosen approach meets the following criteria:

- Prevention of regulatory arbitrage
- Enabling effective investor disclosure (and retail investor protection)
- Taking account of future innovation in the asset management space (more convergence, e.g. classical investment funds embracing many more techniques pioneered by hedge funds)

More generally, it is important to highlight that the classification “hedge fund” is not a reflection of the riskiness of the product/fund, but more a reflection of the sophistication/type of investment techniques employed by the manager (see illustration below). ASIC refers to “more diverse and complex risks” that hedge fund investors are exposed to than investors in funds pursuing more “vanilla” strategies (p.8-9). The HFSB agrees that the risk profile of hedge funds can be different of “vanilla” strategies, but many of the techniques employed (hedging, short selling, etc.) can help to reduce the overall volatility of the product (i.e. exposure to market risk), while introducing a much higher exposure to the idiosyncratic “skill risk” of the individual manager which requires thorough investor due diligence.

Investment risk versus complexity of investment strategy



Therefore, the disclosure requirements for hedge fund managers need to cater more for enabling the investor to assess the nature of the investment strategy and "skill" of the manager.

B1Q6 Should our disclosure guidance also apply to funds that do not, or do not intend to, engage in the strategies listed but that reserve the right to do so without notice to investors?

B2 Q1-Q3: no comment

Benchmarks and disclosure principles for hedge funds

B3Q1: Have we identified the relevant benchmarks?

The chosen benchmarks "valuation and custody of assets" and "periodic reporting" are extensively covered in the Hedge Fund Standards. In relation to periodic reporting, the Disclosure (A) and Risk section (C) of the Hedge Fund Standards[4] provide extensive guidance on the relevant disclosures to investors. There is also significant focus on up front disclosure to investors. The following list provides an overview on how ASIC's approach is mirrored in the Hedge Fund Standards, and where the Standards differ, or go beyond.

a) Valuation and custody of assets

- RG 000.38 (a): Standard 5.1. (Valuations)
  - The HFSB believes that the most satisfactory way to mitigate conflicts of interest in the valuation process is by appointing an independent and competent third party valuation service provider (Standard 5.1). The HFSB has also set out standards for situations where valuations are done in house (see Standard 5.2), and mechanisms for mitigating conflicts of interest in such situations, as well as disclosure to investors (Standard 6), for example regarding the relevant governance arrangements, potential involvement of the investment team in the valuations, and the approach to hard to value assets.
  - The HFSB refers more generally to "independent third party valuation service providers", rather than specifically to administrators (see the HFSB Consultation Paper CP2[5] on Administration and Safekeeping (p.2) for the distinction of roles in the area of administration, custody and valuation). Standard 17a.5 refers to the appointment of independent fund administrators.
  - The HFSB also highlights the importance of ongoing monitoring of service providers (Standard 19.2/19.4). They also mention Service Level agreements (Standard 19.3) to set out the details of the service to be provided.

[4] Hedge Fund Standards: http://www.hfsb.org/?section=11502

[5] http://www.hfsb.org/files/20090701_proposal_to_amend_the_hedge_fund_standards_%28administration%29.pdf (www.hfsb.org -> Standards -> Consultations -> CP2)

- The HFSB has also recently introduced disclosures on the classification of assets (Level 1/2/3 assets) [see recent consultation CP3 on the rationale for these disclosures][6]. This ties in with ASIC's Disclosure Principle 5: Liquidity.

- RG 000.38 (b): Standard 17a.4 (Safekeeping of assets/operational risk): The HFSB uses the term "safekeeping of the property of the fund", which can include custodians and prime brokers.
- RG 000.39/40: The HFSB is based on comply or explain. Thereby, managers will need to explain where they deviate from the stated practice.

b) Periodic reporting:

The proposed approach is in line with many of the requirements set out by the HFSB in Standard 1 (investment policy and risk disclosure) and Standard 16 (risk disclosure). Examples of further information to be made available to investors include changes to the investment strategy and items in relation to the manager's business or fund such as key staff changes (Standard 1.5), the aggregate value of assets under management in a given investment strategy (Standard 1.1 and 2.4).

ASIC could refer to the Hedge Fund Standards and guidance in all these areas, and in particular refer to the Standards where managers choose to deviate from the stated practice, for example by having an in-house valuation function to ensure adequate disclosures are provided to investors.

B3Q2: Are there any other benchmarks we should include?

The HFSB would like to comment on some of the areas included in table 3 on page 24 in the Consultation Paper and the relevant disclosure principles:

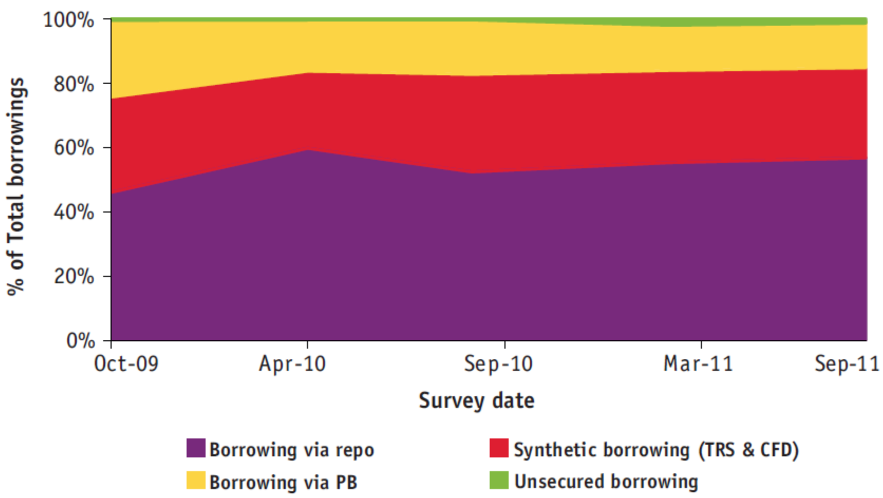
- Liquidity profile of assets and liabilities/Disclosure Principle 5: It is important to highlight that this might require a "qualitative expert assessment" by the manager (or the party in charge of valuations) and as indicated in the UK FSA's Hedge Fund Report (p.13, Maturity transformation), there are challenges to measuring liquidity profile of assets and liabilities and it is important for investors to understand that results might not hold during stressed market conditions.
- Leverage/Disclosure principle 6: the ongoing discussions on leverage in the context of the European regulatory framework for alternative investment managers (AIFM-Directive) highlight the challenges in agreeing on a single meaningful definition of leverage. More generally, the crisis has shown that overreliance on a singular risk measure can be dangerous (see discussion on VAR). Leverage can mean many things depending on the context: for example, in many instances, leverage is not a standalone measure of risk, but is merely a means of measuring underlying volatilities (and thus only useful in the context of other risk information). Gross leverage measures may be useful from a regulatory perspective to assess the "footprint" of the hedge fund industry (see UK FSA Hedge Fund

[6] HFSB Consultation Paper CP3: http://www.hfsb.org/?page=11474 (page 14 – Consistency in Valuation Disclosure)

report, page 10)[7], therefore, great care is needed in using and communicating leverage to ensure it is properly understood and applied. The HFSB seeks to drive better understanding in the area of leverage by asking managers to provide "an explanation of the circumstances in which the fund may use leverage, sources of such leverage, 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" (Standard 1.1), which is also reflected in Disclosure Principle 6. An overview of different leverage definitions is included in the final report of the HFWG published in 2008.[8] The HFSB does not prescribe a particular leverage measure.

- There is mention of "liquidity profile of leverage": This could be renamed more generally into "liquidity profile of liabilities", which would more consistently mirror the "liquidity profile of assets".
- It is also important to highlight that the maturity profile of liabilities of a bank (balance sheet) or a corporate entity is straight forward, leverage is usually created differently in the asset management context, for example via short selling, derivatives or repos (see illustration below). Also, Q4 2008 has shown that negotiated liquidity facilities were quickly renegotiated.
- It is worthwhile mentioning that there are industry attempts to come up with meaningful ways to define the above, including the Opera Risk reporting framework, backed by both managers and investors.

Sources of Hedge Fund Borrowing (Source: UK FSA Hedge Fund Survey 02/2012, page 11)



The above is notwithstanding the question whether retail investors will be in a position to assess the proposed disclosures adequately, and be able to make well informed investment decisions on this basis.

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[7] UK FSA: Assessing the possible Sources of Systemic Risk from Hedge Funds (02/2012): www.fsa.gov.uk/static/pubs/other/hedge-fund-report-feb2012.pdf

[8] See Hedge Fund Standards, Appendix A, p. 34: http://www.hfsb.org/files/hedge_fund_standards_-_february_2012.pdf

B3Q3: Have we included anything that is not relevant?

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B3Q1: Have we identified the relevant benchmarks?

The benchmarks identified by ASIC are relevant. Standard 16 sets out in more detail the relevant risk disclosures proposed by the HFSB. It is important to highlight that the disclosure framework should provide leeway for the inclusion of many different approaches to risk management and not narrowly focussing on singular risk measures (whether it is VAR, leverage or others).

B4Q1: Have we identified the relevant disclosure principles? / B4Q2: Are there any other disclosure principles we should include? / B4Q3: Have we included anything that is not relevant?

RG 000.47-RG 000.54 mirror many of the standards and guidance set out by the HFSB, including the description of the fund's investment strategy, use of derivatives and leverage, and the process to make changes to the investment strategy and disclosures about the investment manager. In its recent amendments to the Standards, the HFSB has expanded the Standards around the handling of changes to the investment strategy (Standard 1.3), a topic which is closely interlinked with fund governance (Standard 21). The HFSB also covers due diligence and monitoring of service providers (RG 000.54).

The HFSB would like to encourage ASIC to proactively reference or use the HFSB Standards in the context of its regime.