SBai

Standards Board for Alternative Investments

The Alternative Investment Standards

1. Introduction

1.1 How to read the Standards

The Standards are set out in a consistent format in blue shaded boxes throughout this document. The formatting of the text within the boxes is differentiated to reflect the following elements*:*

- The Standards **(in bold)**
- Additional guidance and examples which are intended to assist and illustrate how compliance might be achieved (in normal text)
- Explanations and comments *(in italic)*.
- References to a "fund manager" or "manager" means an alternative investment manager that became a signatory to the Standards.

Illustration

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

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

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

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

1.2 Applicability of the Standards to particular types of management activity

We should emphasise that the Standards have been designed to be applied to fund managers solely in respect of their management activities in relation to funds for which they act as the investment manager.

Note: Amendments made in 03/2021 reflect updating links in guidance notes to the most up to date information and format changes only. The latest amendments to the Standards were made in 11/2015, following CP4

They do not apply to other activities including, by way of example, management activities in relation to segregated accounts or fund of funds although certain of the Standards might, with or without adaptation, be appropriate for fund managers to utilise in carrying out those other activities.

We would have no objection if a fund manager, for the avoidance of any doubt, specified in its Disclosure Statement and on its website any areas of its business to which the Standards are applicable.

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

1.3. The Fund versus the Manager

The SBAI 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 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.

1.4 Disclosure in the Manager's own Marketing Materials

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

1.5 Comply or Explain

Conformity with the Standards is through a comply-or-explain regime, the foundation of which is disclosure. The alternative investment industry is diverse by size, strategy, and jurisdiction and therefore a one-size-fits-all approach is not suitable. A comply or explain regime has the advantage of allowing all managers to participate and gives investors more information on which to base their investment decisions. This is not to suggest that “explaining” is an inferior option to “complying”. The SBAI encourages managers to provide explanation even in those areas where it complies with the Standards, to enable better investor due diligence.

A. Disclosure to Investors and Counterparties [1]-[4]

Appropriate disclosure to investors is crucial in enabling well informed investment decisions. Also, counterparties require adequate information to satisfy their risk assessment and regulatory requirements and make well informed lending decisions.

The following areas are particularly relevant:

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

Investment Policy and Risk Disclosure - Standards and Guidance [1][10]

1.1 An appropriate level of disclosure and explanation of the fund's investment policy/strategy and associated risks should be included in the fund's offering documents.[11]

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

– an appropriate description of the investment strategies and techniques employed, and prominent disclosure of the risks involved (Standards [16], [18], [20] and [22] also deal with risk disclosure);

– general details of the investments and instruments (including, for example, derivatives) likely to be included in the fund's portfolio;

– details of any investment restrictions or guidelines and of the procedures the manager will follow in respect of any breaches;

– an explanation of the circumstances in which the fund may use leverage, the 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

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

– to the extent permitted by applicable law and regulation, the target return for the fund's strategy, if applicable;

[10] In conforming to these standards, managers may wish to consult the CFA Institute's Asset Manager Code of Conduct –Selection F (Disclosure) and other industry guidance.

[11] See introduction, chapter 1.3: The fund versus the manager

- the target level of risk for the fund's strategy;
- to the extent permitted by applicable law and regulation, the historical track record of the fund's 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.

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

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

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

1.4 A statement explaining how the fund has invested its assets during the relevant period in accordance with its published investment policy should be included in the fund's annual report.[12]

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

1.5 A 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 SBAI 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.

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 and (b) any material formal regulatory enforcement proceedings against it.

[12] See introduction, chapter 1.3: The fund versus the manager

- For these purposes, the SBAI 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 SBAI 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 SBAI 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.

Commercial Terms Disclosure – Standards and Guidance [2][13]

2.1 The commercial terms applicable to the relevant interests being offered in a particular 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).[14]

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

- fees and expenses:
  - fair disclosure of the methodology used to calculate performance fees;
  - details of any other remuneration received by the manager in connection with its management of the fund (this will be relevant, for example, where a 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, a description of other material fees, costs, and charges which will be payable by the fund;
  - if applicable, the fact that the fees and expenses payable to service providers may change.
- termination rights:

[13] Managers may require further guidance, as set out by GIPS on disclosure of fees and cost (section F), www.gipsstandards.org

[14] See introduction, chapter 1.3: The fund versus the manager

- details of the circumstances in which the fund is entitled to terminate the manager's appointment and the terms (e.g., in relation to termination fees) of such termination.

– exit terms (in the case of open-ended funds):
  - the period of notice investors are required to give to redeem their investment in the fund;
  - the circumstances in which redemption requests can be revoked (e.g., redemption requests may be irrevocable except with consent of the fund governing body);
  - details of any redemption penalties (including, if relevant, any fee or penalty applicable where redemption requests are revoked);
  - details of any "lock-up" periods during which the investor will be unable to redeem its investment in the fund and any limits on the extent of redemptions on any redemption date (i.e. redemption "gates"); and
  - an indication of circumstances in which normal redemption mechanics might not apply or may be suspended, if any – these could include, amongst other things:
    - a significant reduction in the liquidity of the fund's underlying assets; and
    - distress of one or more of the fund's counterparties (including its prime broker(s)) leading to uncertainty as to the value of OTC contracts or access to / ownership of re-hypothecated assets.
  - Details of any other measures which may be considered by the fund governing body in circumstances where normal redemption mechanics might not apply or may be suspended – for example:
    - fund level gating, investor level gating, lock-ups, suspension of redemptions, penalties for revoking redemption requests *(to the extent that the fund's constitutional documents/offering documents do not already provide for such mechanisms)*
    - side pocketing
    - restructuring the fund to incentivise investors to accept, or switch to an alternative share class offering reduced liquidity (for example, in exchange for lower fees)
  - if relevant, an indication of any circumstances in which any changes to redemption terms may be made without shareholder consent;
  - whether measures to enhance liquidity at the fund level may be considered when redemptions are suspended/restricted (e.g., facilitating transfers of shares/units in the fund subject to ensuring that investors satisfy investor eligibility requirements).

2.2 Changes to the fees and expenses payable by the fund to the manager or parties related to the manager, or the redemption rights available to investors 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 offering documents, or (b) providing advance notice sufficient for investors to redeem prior to the effective date of the changes without penalty.[15]

[15] See introduction, chapter 1.3: The fund versus the manager

2.3 A fund manager should disclose the existence of side letters which contain "material terms"[16], and the nature of such terms. A fund manager is not required to disclose the existence of side letters which contain no material terms.

2.4 Upon request, a fund manager should disclose

(a) Existence of funds, accounts or vehicles managed by it using the same or similar[17] investment strategy,[18]

(b) any material adverse effects which the existence of such other funds, accounts or vehicles may have on investors in the fund,

(c) the aggregate value of asset managed by the manager using the same or similar[17] investment strategy,

(d) the aggregate size of employee or partner interests in the investment strategy,[19]

(e) the existence of any other funds or accounts managed by it which follow the same or similar[17] investment strategy to the fund and which are available for investment only by partners or employees (or their connected persons) of the fund manager,[18, 20] and

(f) in the case of (e) above, the size of such funds and accounts.

Please see below an example of non-binding guidance to determine "similarity".

2.5 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.[15] 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.

---

[16] "Any term the effect of which might be reasonably expected to provide the investor with more favourable treatment than other holders of the same class of shares or interests which enhance that investor's ability either (i) to redeem shares or interests of that class or (ii) to determine as to whether to redeem shares or interests of that class, and which in either case might be reasonably expected to put other holders of shares or interests of that class who are in the same position at a material disadvantage based on the exercise of their redemption rights." (https://katten.com/files/19837_the_fsa_hedge_funds_and_side_letters.pdf)

[17] Similar strategies should be interpreted to include funds, accounts or vehicles managed by an investment management team or individual within the fund manager and which trade <u>substantially</u> in parallel, in whole or in part with the fund. Substantially similar trading patterns over time, rather than overlapping positions by themselves, is the key indicator (i.e., overlapping positions by themselves do not define similarity).

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

[19] For the avoidance of doubt, the Standard requires disclosure of aggregate partner/employee investment in the respective strategy, not a person-by-person break-down.

[20] For the avoidance of doubt, a feeder fund, accessible only to partners or employees (or their connected persons) which only invests into a master fund accessible to external investors through a different feeder does not fall under this disclosure.

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.

2.6 On the establishment of a fund, a fund manager should liaise with the fund's administrator to ensure that the methodology for calculating fees payable to the manager (and in particular performance fees) is agreed in advance. Such methodology should be accurately described in the fund's offering documents.[15]

Further guidance on this topic can be found in the SBAI's Toolbox Memo on Conflicts of Interest in Parallel Funds[21].

Example of non-binding guidance to determine "similarity"

1) The Portfolio Manager or investment team, the investment mandate (i.e., equity, fixed income, macro) and the strategy or style (i.e., market neutral, relative value, trend following) will all need to be the same.

2) Additionally, the "similar" fund or separately managed account will have to have an 80% overlap in the following 4 areas (an example follows each item):
    a) ***Asset classes traded*** (i.e., mortgages, equity, credit, FX) - If the fund is 100% equities, then other funds/sleeves must have at least 80% in equities to be classified as similar.
    b) ***Target risk and return*** - Funds must have similar risk-return targets (measured by Sharpe or Information Ratio) to be classified as similar. Thus, if the fund targets a Sharpe ratio of 1, then "similar" funds must target a Sharpe between 0.8 and 1.2 (+/-20% band).
    c) ***Time horizon of positions*** - If the average holding period for the fund is 3 months, then the holding period for the similar fund needs to be between 2.4 to 3.6 months (+/- 20% band).
    d) ***Average liquidity of positions*** - If the average liquidity profile of the fund is 10 days, then the similar fund needs to have an average liquidity profile between 8 to 12 days to be classified as similar (+/- 20% band).

3) A multi-strategy fund would have to have 80% overlap of allocations among sub-strategies, and the sub-strategies would have to be substantially similar (80%), as in item 2 above.

Performance Measurement - Standards and Guidance [3]

[21] https://www.sbai.org/wp-content/uploads/2016/04/Toolbox-Memo-Case-Study-Conflicts-of-interest-between-parallel-funds-6-March-2020.pdf

Accurate and consistent reporting of investment performance enables investors to make well-informed judgments about their investments and allows them to compare different managers.

> **3.1 A fund manager should, in cases where, in its view, the fund has material exposure to hard-to-value assets, ensure that any disclosure in its own marketing materials relating to the fund's performance is accompanied by a reference to any factors which may be material to the robustness of the performance calculation. Where the funds offering documents include references to the fund's performance, they should include similar references.[22]**
>
> Such factors might, amongst other things, include:
>
> – the percentage of the portfolio invested in what the manager considers to be hard-to-value assets;
>
> – the method used in valuing assets which the manager considers to be hard-to-value; and
>
> – the use of side pockets.

The Global Investment Performance Standards (GIPS) provide a standardised approach to performance presentation to communicate investment results to clients and prospective clients. SBAI welcomes the initiative of GIPS to review the applicability of their existing principles to alternative investment funds.

Disclosure to Lenders/Prime Brokers/Dealers - Standards and Guidance [4]

> **4.1 A fund manager should, subject to obtaining the consent of the fund's governing body, provide, or do what it reasonably can to enable and encourage the fund's administrator to provide, any agreed information reports to the fund's counterparties in a timely manner.**

B. Valuation [5]-[8]

While valuation is generally expressed as a single number it is important to recognise that the single number is merely the expression of a range of potential outcomes that derive from the valuation process. It follows that investors need to be informed about the valuation process and have confidence in its breadth and robustness. The following areas are of particular relevance in this context:

- Segregation of functions in valuation
- Approach to handling and valuing of hard-to-value assets
- Investor disclosure of the governance arrangements and hard-to-value assets

[22] See introduction, chapter 1.3: The fund versus the manager

Further guidance on Valuation in Alternative Credit[23] and Insurance Linked Strategies[24] can be found in the SBAI Toolbox.

Segregation of Functions in Valuation – Governance Standards and Guidance [5]

5.1 Valuation arrangements aimed at addressing and mitigating conflicts of interest in relation to asset valuation should be put in place.[25]

The SBAI believes that the most satisfactory way to achieve this is the appointment of an independent and competent third-party valuation service provider.[25]

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

5.2 Where a fund manager determines the value of any of the fund's assets (whether by performing valuations in-house or providing final prices to a valuation service provider), it should operate a valuation function which is segregated from the portfolio management function and should explain its approach to investors. If a smaller or start-up manager considers it impractical to do so, it should disclose this in its marketing documents. This should also be disclosed in the fund's offering documents.[25]

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

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

Ways to achieve this might include:

- ensuring that valuation staff provide periodically a report on the valuation process to the fund governing body;
- the formation of a designated "valuation committee" (no member of which is involved in investment decisions);[30] and

[23] https://www.sbai.org/wp-content/uploads/2020/05/SBAI-Alternative-Credit-Valuations-Memo-20-May-2020.pdf

[24] https://www.sbai.org/wp-content/uploads/2019/05/SBAI-Valuation-of-Insurance-Linked-Funds-7-May-2019.pdf

[25] See introduction, chapter 1.3: The fund versus the manager

- employing the services of an appropriate external party to evaluate the effectiveness and robustness of the valuation procedures in place and report to the fund governing body (or its valuation committee).

Fund managers also could refer to The SBAI Toolbox Memos on Valuation for Alternative Credit[26] and Insurance Linked Strategies[27], as well as publications by standard setters and regulators, including IOSCO's Principles for the Valuation of Collective Investment Schemes (2013)[28] and IOSCO's Principles for the Valuation of Hedge Funds (2007)[29]for further guidance in this area.

Segregation of Functions in Valuation – Disclosure Standards and Guidance [6]

6.1 A document (a "Valuation Policy Document") covering all material aspects of the valuation process and valuation procedures and controls in respect of the fund should be prepared.[30] The Valuation Policy Document (which it is acknowledged will contain information which is proprietary to the fund manager) should be reviewed regularly by the fund manager, in consultation with the fund governing body, and be made available to investors upon request on a confidential basis.

The SBAI envisages that in most circumstances the Valuation Policy Document will describe:

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

6.2 Where a fund manager is involved in the valuation process, it should disclose in its own marketing materials any actual or likely material involvement of the portfolio management team in the valuation process. Such disclosure should also be included in the fund's offering documents.[31] Investors should then be informed, for example via manager newsletters, of any material changes to such level of involvement.

---

[26] https://www.sbai.org/wp-content/uploads/2020/05/SBAI-Alternative-Credit-Valuations-Memo-20-May-2020.pdf

[27] https://www.sbai.org/wp-content/uploads/2019/05/SBAI-Valuation-of-Insurance-Linked-Funds-7-May-2019.pdf

[28] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD413.pdf

[29] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD240.pdf

[30] See introduction, chapter 1.3: The fund versus the manager

[31] See introduction, chapter 1.3: The fund versus the manager

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

Hard-to-Value Assets – Governance [7]+[8]

Hard-to-Value Assets – Governance Standards and Guidance [7]

7.1 Where a fund manager performs in-house valuations of hard-to-value assets or is otherwise involved in providing final prices to the valuation service provider, valuation procedures for such assets which are aimed at ensuring a consistent approach to determining fair value should be adopted and such procedures should be set out in the Valuation Policy Document.[32]

The SBAI envisages that such procedures would in most circumstances include:

- details of a hierarchy of pricing sources and models to be used for each asset type in a fund's portfolio (where relevant);
- if using broker quotes:
  - making reasonable efforts to identify and draw upon multiple (typically 2-3) price sources (where available);
  - specifying the acceptable tolerance ranges when multiple pricing sources are used and the approach to handling "outliers";
  - ensuring consistency and avoiding "cherry picking" of favourable price sources by using the same brokers at each valuation point; and
  - where the fund manager arranges the provision of broker prices (as opposed to the administrator or other third-party valuation service provider), the fund manager should instruct brokers to send the prices directly to the administrator (or other third party valuation service provider);
- if using pricing models, a process specified in the Valuation Policy Document for[33]:
  - approving pricing models including back-testing, documentation and approval by the fund governing body or its valuation committee;
  - monitoring and verification against observed market prices; and
  - governing manual overrides of the model inputs or results, including approval, documentation and reporting to the fund governing body or its valuation committee.

[32] See introduction, chapter 1.3: The fund versus the manager

[33] See introduction, chapter 1.3: The fund versus the manager

7.2 If using side pockets, a fund manager should ensure that the fund governing body has been consulted on, and consented to, the circumstances in which side-pockets may be used. Furthermore;[34]

- **The types of asset eligible for side pocketing should be described in the Valuation Policy Document and the side pocketing process should be disclosed in the fund's offering documents.**
- **Side-pocketing should occur either on or about the time the relevant asset is purchased or on or about the point at which the relevant asset becomes hard-to-value. The initial valuation of an asset on entering a side-pocket should be at cost[35], the last available market price (as appropriate) or a lower number or nil.**
- **Where a limit to the total amount of assets which may be included in side-pockets is disclosed in the fund's offering documents, such limit should not be breached.**
- **Management fees, for the side pocketed assets, if charged, should be calculated on no more than the lower of cost (or last available market price in the case of a previously liquid asset) or fair value.**
- **Any performance fees should accrue for the duration of the existence of the side pocket and should be paid only at the point at which the asset is finally disposed of or a liquid market price is available.**

Fund managers could also refer to the SBAI Toolbox Memos on Valuation for Alternative Credit[36] and Insurance Linked Strategies[37], as well as publications by industry associations and regulators for further guidance on the valuation of hard-to-value assets.

Hard-to-Value Assets – Disclosure Standards and Guidance [8]

8.1 The percentage of the fund's portfolio that falls into each of the three "levels" prescribed by ASC 820[38] or IFRS 7, or equivalent account standards or recognised definitions (and, where meaningful and applicable, the extent to which internal pricing models or assumptions are used to value certain components of the fund's portfolio invested in hard-to-value assets) should be periodically disclosed (e.g. via newsletters).

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

---

[34] See introduction, chapter 1.3: The fund versus the manager

[35] May be subject to regional accounting standards

[36] https://www.sbai.org/wp-content/uploads/2020/05/SBAI-Alternative-Credit-Valuations-Memo-20-May-2020.pdf

[37] https://www.sbai.org/wp-content/uploads/2019/05/SBAI-Valuation-of-Insurance-Linked-Funds-7-May-2019.pdf

[38] Formerly FAS 157

8.3 The value of side pockets should be reported periodically in the fund's audited annual accounts in accordance with applicable accounting standards.[39]

8.4 A fund manager conducting valuations in-house should discuss with the fund governing body any material issues in relation to the valuation of hard-to-value assets (e.g. unavailability of a sufficient number of pricing sources or dispersion of broker quotes beyond tolerance levels). Such material issues in relation to the valuation of hard-to-value assets should be disclosed to investors.[25]

C. Risk Management [9]-[20]

Risk management is a vital aspect of the fund management process. The following aspects of risk management are addressed in this section:

- Risk Framework [9]-[10]
- Portfolio Risk [11]-[16]
- Operational Risk [17]-[18]
- Outsourcing Risk [19]-[20]

Risk Framework – Governance Standards and Guidance [9]

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

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

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

[39] See introduction, chapter 1.3: The fund versus the manager

Risk Framework - Disclosure Standards and Guidance [10]

> **10.1 A fund manager should explain its approach to managing risk (its risk framework) to the fund governing body. Such risk framework should be explained to the appropriate extent, in the fund's offering documents.[40]**

The following table provides an overview of the different risk categories which should be covered by the risk framework.

Risk Category Overview

Category	Description	Risk for whom	Covered in Standards
Portfolio risks	Risk of losses in the investment portfolio	Direct risk for investors, indirect (reputational) risk for the manager	[11]-[16]
Operational risks	Risk of breakdowns in internal controls or systems which can lead to financial losses	Direct risk for the manager, indirect risk for investors	[17]-[18]
Outsourcing risks	Risk of failures in the delivery of services by third parties	Direct risk for the manager, indirect risk for investors	[19]-[20]

Portfolio Risk [11]-[16]

Portfolio Risk - Governance Standards and Guidance [11]

> **11.1 A fund manager should ensure that adequate risk management processes and resources are available and well understood by portfolio managers, traders, risk managers, senior staff and other staff related to the management of the portfolio. A fund manager should also discuss these risk management processes with the fund governing body and do what it reasonably can to assist the members of the fund governing body to understand such processes.**
>
> **11.2 Potential conflicts of interests in the risk monitoring process should be managed by clearly separating the risk monitoring function from portfolio management. If a smaller or start-up manager considers it impractical to do so, this should be disclosed in the fund manager's marketing documents and in the fund's offering documents.[41]**
>
> The SBAI recognises that notwithstanding the separation of the risk monitoring and portfolio management functions, portfolio managers will typically provide input into the risk parameters to be applied to the portfolio (e.g., types of trades, degree of risk and areas of risk).

[40] See introduction, chapter 1.3: The fund versus the manager

[41] See introduction, chapter 1.3: The fund versus the manager

11.3 Risk monitoring reports should be made to the person or body which has ultimate responsibility for risk management (such as the manager's chief investment officer, chief executive officer or management committee).

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

The SBAI expects that in most circumstances the Risk Policy Document might, amongst other things, include:

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

Liquidity Risk Management - Standards and Guidance [12]

12.1 A fund manager should develop a liquidity management framework, the primary role of which is to limit the risk that the liquidity profile of the fund's investments does not align with the fund's obligations.

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

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

12.2 A fund manager should regularly conduct stress testing and scenario analysis of the fund's liquidity position.

Potential stress events could include:

- margin calls due to sudden severe market shocks (e.g., significant equity price falls);
- reduction in liquidity in certain market segments relevant to the fund;
- a sudden increase in collateral requirements for funding positions (thereby reducing assets available for sale to meet liquidity needs);
- investor redemptions (as per the fund's redemption policies) [where relevant[42]]; and

[42] Will only be relevant to open-ended funds

- cancellation of credit lines (as per notice periods agreed between the fund and counterparties such as prime brokers).

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

It has been widely found that in stress situations unexpected correlations can appear. Some funds have faced sudden liquidation challenges due in part or in whole to rapid market movements, for example in currencies, commodities, or equities.

Market Risk Management - Standards and Guidance [13]

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

These could include, amongst others:

- volatility measures;
- VaR type approaches;
- Monte Carlo simulation[43];
- stress tests/scenario analyses[44];
- impact of leverage; and
- portfolio concentration measures.

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

Extreme financial events may not receive sufficient attention when using classic risk measures such as volatility and VaR due to the scarcity of historical observations for such events. Stress testing/scenario analysis allows managers to overcome this shortcoming by accounting for the increased inter-correlation between different asset classes at times of market turmoil.[45]

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

The analysis could include, amongst other things, scenarios based on historically observed crises (e.g., the 2000 new economy bubble burst or the sub-prime mortgage crisis in 2007) and newly

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

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

[45] Also sometimes referred to as "fat tails", i.e. extreme occurrences are more likely than theoretically expected

developed ("made-up") scenarios to incorporate emerging correlations and new risks, and their respective impact on the portfolio.

Fund managers should also assess basis risk arising from imperfect hedging strategies [46] and incorporate resultant uncertainties into their stress testing/scenario analysis approach.

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

In times of abrupt market fluctuations, situations can arise where market liquidity is much lower than it is usually observed, making it difficult to trade positions at observed market prices. Under such circumstances, a fund's net asset value may not only be hard to calculate, but also unattainable in the event sales are attempted. At the same time, the manager might be forced to sell positions, for example in order to meet redemption requests and/or margin calls.

The risk measurement framework should account for this, for example by applying valuation discounts for modelling purposes to positions that might have to be liquidated under stressed conditions (see Standard [12] *(Liquidity risk management)*).

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

Counterparty Credit Risk Management - Standards and Guidance [14]

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

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

14.2 Creditworthiness of the fund's trading counterparties should be monitored periodically, and risk limits adjusted, if required.

Control Processes - Standards and Guidance [15]

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

To assist in tracking a fund's adherence to its stated investment objectives, investment policy/strategy and investment and other restrictions, fund managers should carefully consider

[46] E.g., when the price of a future varies from the price of the underlying instrument as expiry approaches; the more immature the market, the more imperfect the hedging strategies are likely to be.

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

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

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

Portfolio Risk - Disclosure Standards and Guidance [16]

16.1 A fund manager should disclose and explain its investment and risk management approach in its own marketing materials. Such disclosure and explanation should also be included to the appropriate extent in the fund's offering documents.[47] In addition to disclosure recommended in Standard [1] (*Investment policy and risk disclosure*), a summary of the risk framework (processes and risk management techniques employed) should be disclosed.

Fund managers should also carefully consider whether it would be appropriate to disclose target ranges or averages as anticipated by the manager for specific risk parameters and how short-term deviations from such target ranges are handled and advise the fund governing body accordingly. This could include:

- volatility of returns;
- VaR or equivalent (e.g., potential loss arising from a stress event);
- leverage (according to the manner in which the manager measures leverage)[48]; and
- limits to the percentage of the portfolio which can be invested in non-marketable securities[49] (or another measure of liquidity).

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

[47] See introduction, chapter 1.3: The fund versus the manager

[48] See Appendix A for examples of leverage measures

[49] Marketable Securities: Securities that can be easily liquidated, e.g. government securities, stock, bonds, notes, commercial paper, and other financial instruments that are regularly listed for sale on recognised public exchanges

The SBAI envisages that this might include:

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

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

The SBAI acknowledges that investors may require more frequent disclosures via newsletters than the annual disclosures set out above. However, the frequency, required content and granularity of such disclosures will be a function of the fund's strategy. For example, high turnover strategies may require more frequent disclosure than private or distressed debt strategies. Risk measures used may also differ substantially between funds. Therefore, the SBAI has not sought to be prescriptive in this area.

Operational Risk [17]+[18]

Overview of areas covered:

- People and Governance [17a]
- Trading and Execution [17b]
- Fraud and Financial Crime Prevention [17c]
- Disaster Recovery [17d]
- Model Risks [17e]
- IT Security [17f]
- Legal and Regulatory Risk [17g]
- Personal Account Dealing [17h]
- Trade Allocation [17g]
- Conflicts of Interest [17j]

People and Governance - Governance Standards and Guidance [17a]

17a.1 In areas where potential conflicts of interest could arise (valuation, risk management, compliance), a fund manager should clearly divide these activities from the portfolio management function with separate reporting lines into the manager's chief executive officer or chief investment officer or similar. If a smaller or start-up manager considers it impractical

to do so, it should disclose this in its marketing documents and such potential conflicts of interest should also be disclosed in the fund's offering documents.[50]

17a.2 A fund manager's staff remuneration should not set false incentives (e.g., by linking the compensation of the valuation team directly to fund performance).

17a.3 A fund manager should ensure that material aspects of its operational procedures are adequately documented, and training is provided to staff. This should include, amongst other things, areas such as compliance procedures, back-up/disaster recovery procedures, and client confidentiality. A fund manager should also periodically test its compliance procedures or have them audited by an external party.

17a.4 One or more third parties, independent of the manager, should be appointed to be responsible for the safekeeping of the property of the fund.[51]

– The SBAI acknowledges that in the case of master feeder structures, it will not be appropriate for the feeder fund, which will normally hold shares/interests in the master fund and some cash, to appoint a third party responsible for safekeeping its assets. In such circumstances, appropriate due diligence should be conducted on the master fund and the arrangements in place for the safekeeping of its assets.

– The SBAI acknowledges that prime brokers may take charges and/or security interests over the assets of a fund or may hold fund assets as collateral.

17a.5 A third party, independent of the manager, with responsibility for fund administration (including calculation of the NAV and the maintenance of the accounting records of the fund) should be appointed in order to ensure the segregation of functions and the avoidance of conflicts of interest in relation to the provision of fund administration services.

- The SBAI acknowledges, however, that in some cases, it will not be possible in practice to achieve both independence and the required level of competence and service quality by appointing a third-party provider.
    - In such instances the manager should ensure that the internal function in charge of the calculation of the NAV and the maintenance of the accounting records are kept segregated from the portfolio management and trading divisions. Such function should be properly resourced and carried out by staff who have appropriate expertise. This function should report to senior management of the firm.
    - The internal function in charge of the calculation of the NAV and the maintenance of the accounting records of the funds should be audited annually by an independent auditor.

Issues in relation to the valuation process are covered separately and included in Standards 5 and 6.

Issues in relation to due diligence of third-party service providers are also covered separately and included in Standard 19.

---

[50] See introduction, chapter 1.3: The fund versus the manager

[51] See introduction, chapter 1.3: The fund versus the manager

17a.6 The nature, structure and governance of these arrangements should be disclosed.

Issues in relation to disclosure of third-party service providers such as administrators are also covered included in Standard 20.

Operational Risk – Trading and Execution - Standards and Guidance [17b]

17b.1 To prevent trading and execution failures, a fund manager should put effective trading and counterparty procedures in place.

This might include the following aspects:

- entering into master agreements with trading counterparties;
- agreeing well defined termination and collateral policies;
- tracking changes in key provisions of any agreements with trading counterparties; and
- a robust trade confirmation and reconciliation process including, amongst other things:
    - sufficient back and middle-office capacity to handle trading volumes;
    - daily confirmation of trades and positions;
    - use of electronic matching and confirmation systems (depending on the scale of the manager - smaller managers and managers with low trading volumes may rely to a larger extent on manual handling);
    - timely reconciliation of complex over-the-counter trades and loans; and
    - monitoring of corporate action events (e.g., voting, splits, spin-offs) on long and short equity derivative instruments and applying the events to fund accounts.

Operational Risk – Fraud and Financial Crime Prevention - Standards and Guidance [17c]

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

This may apply to areas such as:

- anti-money laundering procedures[52] (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))*.

17c.2 A fund manager should appoint a compliance officer who is independent of the portfolio management function to oversee all issues relating to regulatory compliance and market and professional conduct. If a smaller or start-up manager considers it impractical to do so, this

52

should be disclosed in the fund's offering documents.[53] **The compliance officer should report regularly to the manager's chief executive officer or management committee or equivalent. A fund manager should provide to the fund governing body a report on regulatory compliance prepared by the compliance officer on a regular basis.**

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

Further guidance on this topic can be found in the SBAI's Governance Toolbox in the Cash Handling and Cyber Security Memo[54]*.*

Operational Risk – Disaster Recovery - Standards and Guidance [17d]

17d.1 A fund manager should put in place measures designed to ensure that the provision of fund management services to the fund will remain possible in the event of a disaster. The level of tolerance should be agreed by the executive committee of the fund manager and, where relevant, be notified to the fund governing body.

Depending on the scale of the fund manager's business, this could include:

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

Operational Risk – Model Risk - Standards and Guidance [17e]

17e.1 As part of its operational risk management procedures, a fund manager should assess any exposure to model risk annually or as dictated by events and where model risk is perceived to be material to the performance of the manager, should implement appropriate procedures to ensure that material model risks are identified and mitigated where possible.

Such procedures might include:

- evaluation of model risk in the model selection process;
- frequent review of models, including parameterisation, calibration, assumptions and data integrity;
- stress testing of assumptions;

[53] See introduction, chapter 1.3: The fund versus the manager

[54] https://www.sbai.org/wp-content/uploads/2016/04/Toolbox-Memo-Cash-Handling-Cyber-Security-Final.pdf

- sign-off and documentation of management overrides (overrides can become necessary when models produce unreasonable results so that human intervention becomes necessary, but such overrides need to be governed carefully);
- documentation of models to avoid key man risk; and
- security of algorithm and source code (back-up).

Further guidance on this topic can be found in the SBAI's Alternative Risk Premia Toolbox in the Back-testing Memo[55].

Operational Risk – IT Security - Standards and Guidance [17f]

17f.1 A fund manager should ensure security and integrity of systems and data.

Depending on the scale of the manager, this could include system testing, offsite IT and data back-up, disaster recovery procedures and supervision of contract IT resources.

Operational Risk – Legal and Regulatory Risk - Standards and Guidance [17g]

17g.1 A fund manager should ensure that it understands local conduct of business rules and regulations which apply in the jurisdictions in which it operates (including any rules governing the passporting of regulatory authorisations from one jurisdiction to another). A fund manager should also ensure that it understands laws and regulations relevant to the securities in which it trades (e.g., shareholding disclosure requirements and foreign ownership rules).

Operational Risk – Personal Account Dealing [17h]

17h.1 A fund manager should adopt a personal account dealing policy for its staff, ensure awareness of this, 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.

Operational Risk – Trade Allocation policy [17i]

17i.1 A fund manager should put in place a trade allocation policy.

17i.2 Upon request, a manager should disclose the trade allocation policy to investors on a confidential basis.

Further guidance on this topic can be found in the SBAI's Governance Toolbox in the Conflicts of Interest in Parallel Funds Memo[56].

---

[55] https://www.sbai.org/wp-content/uploads/2020/07/Toolbox-Memo-Backtesting-15-July-2020.pdf

[56] https://www.sbai.org/wp-content/uploads/2016/04/Toolbox-Memo-Case-Study-Conflicts-of-interest-between-parallel-funds-6-March-2020.pdf

Operational risk – arrangements to address conflicts of interest [17j]

17j.1 A manager should ensure that it has internal arrangements to manage and mitigate conflicts of interest, and this should include documented compliance policies and procedures (e.g., conflicts of interest policy). Conflicts of interest should be recorded and reported to senior management on a periodic basis (e.g., monthly or quarterly) or, in the case of conflicts requiring the approval of senior management, escalated as soon as reasonably practical. Where applicable, conflicts of interest should be reported to the fund governing body.

Examples may include, but are not limited to:

a) Cross trades

b) Fair allocation of trades / opportunities across different funds or accounts

c) Employee/partners funds

d) Funds that in turn invest in other internal/external funds with incremental fees

e) Internal resource allocation across different funds/client accounts

f) Personal Account dealing policies

g) Allocation of expenses

h) Use of affiliated service providers

i) Lack of independent valuation

j) Differential terms or fees

k) Use of soft dollars/dealing commissions

l) Other business interests of investment manager employees

m) Gifts and entertainment

n) Suspension and/or gating of redemptions.

Operational Risk - Disclosure Standards and Guidance [18]

18.1 To enable investors and creditors to be confident that operational risks are managed satisfactorily, a 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 disclosures might include:

- **the manager's "soft-dollar" policy or "use of dealing commissions" policy and practices.**

Outsourcing Risk [19]+[20]

The alternative investment industry is traditionally based on a strongly unbundled business model, with managers focusing on what they are best at – managing the portfolio – while third parties provide other services such as administration, valuation, custody, and prime brokerage.

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

Outsourcing Risk - Governance Standards and Guidance [19]

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

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

This could include using Due Diligence Questionnaires or evaluating "reports on controls" from an independent reporting accountant issued by the respective third-party service provider.[57]

19.2 Third party service providers should be regularly reviewed.[58]

Valuation and administration

19.3 Where appropriate, a service level agreement ("SLA") should be put in place with relevant service providers (commonly, this will be attached as a schedule to the agreement between the fund and the relevant service provider).[59]

An SLA would normally be expected to:

- set out in precise detail the services to be provided by the relevant service provider along with deadlines for completion of the services;
- make clear accountability and responsibility for the orderly operation of all administration or other functions performed by the relevant service provider on behalf of investors; and
- include "Key Performance Indicators" to provide fund managers and fund governing bodies with a means of measuring whether the objectives set out in the SLA are met by the relevant service provider.

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

---

[57] Reports on controls under the ISAE 3402 (international), SAE16 (US), AAF 01/06 (UK) or other standards include a report from an independent service auditor

[58] See introduction, chapter 1.3: The fund versus the manager

[59] See introduction, chapter 1.3: The fund versus the manager

19.4 The services provided by the relevant service provider should be reviewed and monitored against contractual or other agreed standards.[60]

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.

Prime brokers

19.6 A fund manager of a large fund should carefully consider whether it is appropriate for the fund to appoint more than one prime broker (taking into account in particular the potential advantages of diversification of funding and other services).

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

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

Auditors

19.7 Reputable auditors should be appointed to audit the financial statements of the fund.[61]

Outsourcing Risk - Disclosure Standards and Guidance [20]

20.1 A fund manager should disclose the names of its principal third party service providers in its due diligence documents or upon request.

20.2 A fund manager should, to the extent it is able or permitted to do so, provide information on the fund's committed funding or financing arrangements with prime brokers/lenders to investors in its due diligence documents or upon request.

20.3 A fund manager should disclose the nature of any special commercial terms with its third-party service providers which result in potential conflicts of interest (e.g., in-house brokerage or rebates).

20.4 A fund manager to the extent applicable should disclose the monitoring procedures in relation to its third-party service providers in its due diligence documents or upon request.

[60] See introduction, chapter 1.3: The fund versus the manager

[61] See introduction, chapter 1.3: The fund versus the manager

D. Fund Governance [21]+[22]

Potential conflicts of interest can arise between fund managers, the funds which they manage and investors in those funds. To mitigate these potential conflicts, appropriate governance mechanisms and oversight are required.

An important issue to consider on establishing a fund, therefore, is the mechanism for addressing and containing such potential conflicts of interest. This issue may not have been accorded great importance when the alternative investment industry was in its infancy; perhaps reflecting the fact that the relationships between managers and their relatively few private investors were more informal or that managers themselves may have been the main investors. As such, these relationships were essentially based on mutual knowledge and trust at that time. As the industry has grown, however, the investor base has broadened with more and more institutional investors (insurance companies, pension funds, endowments and so on) and funds of funds starting to invest in alternative investment funds. The SBAI considers that this change in the investor base requires a reinforcement of oversight processes.

Of course, not all alternative investment funds are the same and so practices in any particular case may need to reflect the investor base, the size and age of a fund and other relevant factors. The legal structure will also need to be taken into account, with the governance mechanism applicable in the case of a fund structured as a company, for example, differing from that applicable in the case of a limited partnership or unit trust. This indicates a "spectrum" of acceptable governance approaches.

Conceptually, the SBAI believes that in most cases the preferred model involves establishing a fund governing body comprising a majority of independent directors, who are suitably qualified and experienced such that they are comfortable holding the manager to account for its performance and conduct. The SBAI recognises, however, that, amongst other things, the nature of the investor base, market practice in certain jurisdictions, the legal structure of the fund and the availability of individuals to serve on fund governing bodies will in some cases legitimately result in alternative governance mechanisms being adopted.

Where the preferred model outlined above is not adopted (for whatever reason), the SBAI believes that it is appropriate to consider whether the fund's constitution or offering documents should provide for certain decisions or actions (for example, material changes to fees, investment strategy, etc.) to be made or taken only with investor consent (obtained in accordance with the provisions relating to investor voting/ consent/approvals contained in the fund's constitutional documentation or offering documents) or, if applicable, where advance notice has been given sufficient for investors to redeem their investments before such decisions or actions take effect.

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

Further Guidance can be found in the SBAI's Governance Toolbox on running a Fund Board meeting and a standardised Board Agenda[62].

Fund Governance - Standards and Guidance [21]

21.1 Prior to the establishment of a fund, a fund manager should assess where the fund governance structure should lie on the "spectrum" (see above). In light of that assessment, the manager should be proactive in seeking to ensure that a fund governance structure which is suitable and robust to oversee and handle potential conflicts of interest is put in place at the outset.

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

- the range of relevant skills and experience of the members of the fund governing body and the extent to which the fund governing body is able adequately to supervise, and hold to account, the fund manager; and
- the extent to which the fund governing body is able to operate independently of the 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) 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 offering documents) or if advance notice is provided sufficient for investors to redeem before such actions take effect.

For the purposes of this Standard, the SBAI 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 exceptions:

The SBAI 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 a limited partnership fund). 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.

21.3 Members of the fund governing body should have suitable experience and integrity in order to discharge effectively their role with the appropriate level of independence.[63]

21.4 The composition of the fund governing body and the governance processes in place should be monitored and, if necessary, adjusted throughout the life of the fund to ensure that they remain

[62] https://www.sbai.org/wp-content/uploads/2016/04/Standardised-Board-Agenda-6-November-2019.pdf

[63] See introduction, chapter 1.3: The fund versus the manager

effective and appropriate in light of, amongst other things, changes in the nature of the fund and its investors.[64]

21.5 The fund governing body should meet regularly and conduct such meetings in a manner which safeguards the intended legal, regulatory and tax status of the fund. Such meetings should be appropriately documented.[65]

- In normal circumstances the SBAI would expect fund governing bodies to meet at least quarterly.

21.6 Careful consideration should be given to the extent to which the adoption by the fund governing body of all or parts of established codes of corporate governance or other director guidance is appropriate. [67] Fund governing bodies should be adequately resourced in order to comply with any such corporate governance code or director guidance.[66] This includes ensuring that the fund governing body has adequate resources to comply with any such corporate governance code or director guidance.

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

As guidance to managers when considering which corporate governance code or director guidance are appropriate for fund governing bodies to adopt, the SBAI has set out below a selection of those principles contained in the corporate governance codes and director guidance published by AIC and AIMA which it considers to be of greatest importance[67]. The SBAI recognises, however, that not all of these principles will be applicable to all types of alternative investment funds:

- directors' potential conflicts of interest should be disclosed fully to the fund's investors (through the fund's offering documents) and the board as a whole (at the first available meeting);
- fund boards should have sufficient collective expertise, availability and be otherwise qualified to understand the investment policy and strategies of the fund and the attendant risks (AIC 6) . Expertise should include areas, such as investment management, regulatory issues, accounting, administration and technical understanding of the fund's strategies;
- the board should put in place a policy on tenure of directors and disclose it in the fund's offering documents and its annual report (AIC 4);
- directors' remuneration should reflect their duties and responsibilities, and the value of their time spent (AIC 8);
- regular face to face board meetings should be held, preferably quarterly. Typical board agendas may include approval of accounts, investment performance review, review of any relevant regulatory breaches and review of the performance of third-party service providers,

[64] See introduction, chapter 1.3: The fund versus the manager

[65] See introduction, chapter 1.3: The fund versus the manager

[66] See introduction, chapter 1.3: The fund versus the manager

[67] AIC: Association of Investment Companies: The AIC Code of Corporate Governance, https://www.theaic.co.uk/sites/default/files/documents/AIC2019AICCodeofCorporateGovernanceFeb19.pdf

such as the administrator and prime broker(s), review of the manager's risk management procedures;

- there should be regular review of adherence by the manager to investment policy and investment restrictions, review and approval of side letters, compliance and valuation functions and regular review of business continuity.
- the manager, external valuation agent and administrator should be required to report regularly to the fund directors regarding performance, subscriptions, redemptions and adherence to investment policy and restrictions and applicable anti-money laundering requirements (including direct reporting from the compliance officer and any in-house valuation function)
- the fund directors should be made aware of their personal responsibility for the issuance and legality of side letters or discretionary waivers (AIMA 6.9 and 6.11); and
- the directors should consider whether the fund should take out D&O insurance proportional to any liabilities relating to the directors' role with respect to the fund.

21.7 Regular reports on compliance with laws and regulations (in particular those relating to anti-money laundering) applicable to activities which are performed by the administrator on behalf of the fund should be obtained by the fund governing body from the fund's administrator.[68]

Fund Governance – Disclosure Standards and Guidance [22]

22.1 Details of the fund governance structure which is put in place should be disclosed in the fund's offering documents.[69]

This could include elements such as:

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

22.2 The existence of any class of shares which are held only by the manager (or an entity connected with the manager) and which carry voting rights affecting any aspect of decision-making in respect of the fund should be disclosed in the fund's offering documents.[70]

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

---

[68] See introduction, chapter 1.3: The fund versus the manager

[69] See introduction, chapter 1.3: The fund versus the manager

[70] See introduction, chapter 1.3: The fund versus the manager

E. SHAREHOLDER CONDUCT, INCLUDING ACTIVISM [23]-[28]

This section focuses on fostering behaviours which contribute to market integrity and shareholder engagement. The following areas are covered:

- Prevention of Market Abuse [23] + [24]
- Proxy Voting [25] + [26]
- Disclosure of Derivative Positions [28]
- Borrowing Stock (to vote) [27]

Prevention of Market Abuse – Governance Standards and Guidance [23]

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

A sound approach might include the following components:

- a dedicated compliance officer who is not involved in the investment management process;
- a written compliance document describing all relevant compliance procedures;
- documentation of all compliance incidents by the compliance officer in accordance with, where relevant, applicable regulatory requirements;
- training/education of investment management and other staff to ensure that the relevant laws and regulations, the relevant compliance procedures and what constitutes inside information are all understood and adhered to;
- the provision of regular compliance reports to the fund governing body;
- seeking legal and regulatory guidance to ensure that compliance arrangements are designed to prevent regulatory breaches; and
- open relations with its regulator.

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

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

Abuse	Procedure
Insider dealing	▪ Notification to the compliance officer if an employee believes he/she has received inside information. ▪ Compliance officer to determine whether information is material and non-public. ▪ If information is material and non-public, the securities of the issuer concerned should be placed on the restricted list (in which case such stocks cannot be traded) or on a grey list (non-disclosed restricted list, which prevents such information from being shared with the entire firm such that it might allow personnel to second guess why something was restricted). ▪ Securities (shares, bonds, etc.) of companies on the restricted list in which the entire firm would be excluded from dealing (e.g. restricted in the order management system).

Note: Amendments made in 03/2021 reflect updating links in guidance notes to the most up to date information and format changes only. The latest amendments to the Standards were made in 11/2015, following CP4

	▪ Where practicable, use of Chinese walls to prevent, for example, individual portfolio managers who are members of a creditors' committee of a distressed or bankrupt company (and who therefore have access to confidential information) from also trading such company's debt or equity. ▪ In instances where inside information is known to employees who have no active involvement in the investment management function, documentation of details of this knowledge should be placed on a separate (non-publicised) register.
Dissemination of inside information	▪ Managers should have policies to restrict dissemination of material non-public information including, for example, the manager's own intention actively to engage with a company (e.g. by advocating/suggesting a corporate restructuring).
Non-disclosure of shareholdings when disclosure thresholds have been exceeded	▪ Managers should document arrangements with other parties (e.g. other managers) together with which it has adopted a "lasting common policy towards the management of the issuer in question". ▪ Relevant disclosures should take place if disclosure thresholds are exceeded, accounting for collective share ownership of all parties involved.
Prevention of market manipulation	▪ Public relations policies regarding public statements of intent to seek to ensure that no false or misleading impressions are given to the market.

Prevention of Market Abuse – Disclosure Standards and Guidance [24]

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

Examples of potential inside information

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

Proxy Voting – Governance Standards and Guidance [25]

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

The SBAI envisages that a voting policy might include the following elements:

- guidelines as to the process to be followed to decide how to exercise voting rights, including responsibility to vote and mechanisms to resolve potential conflicts of interest;
- a mechanism to review proposals that are not considered to be in the best overall interests of a company in which the fund is invested;
- a process for deciding when and how to communicate with an investee company's management or board of directors and other shareholders; and
- a process for determining whether to join the efforts of other concerned investors, with due regard to compliance procedures to prevent market abuse (see Guidance in Standard [24] *(Prevention of market abuse)*).

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

The SBAI acknowledges that it may not be part of a manager's strategy to vote all proxies (e.g., "black box" traders[71]) and a manager might, for cost benefit considerations, adopt a systematic approach, for example never voting except in exceptional circumstances rather than evaluating each proxy situation. In such circumstances, this should be explained to investors in accordance with the comply or explain regime.

Proxy Voting – Disclosure Standards and Guidance [26]

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

Disclosure of Derivative Positions [27]

Derivatives such as Contracts for Difference ("CFDs") allow investors to obtain economic exposure to stocks. There are many reasons for seeking exposure via derivatives rather than buying the stock directly, including market access, stamp tax and funding/leverage[72]. These derivatives do not normally fall under the same disclosure requirements (in the UK, for example, under the FSA's Disclosure and Transparency Rules[73]) as shares owned outright.[74]

Disclosure of Derivative Positions

The SBAI acknowledges that companies have a right to know who owns them or who has an ability to easily obtain significant voting power.

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

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

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

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

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

Borrowing Stock to Vote [28]

Borrowing Stock to Vote – Governance Standards and Guidance [28]

28.1 A fund manager should not borrow stock in order to vote.

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

Appendix A: Examples for Leverage

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

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

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

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

Examples of leverage measures:

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

Appendix B: Examples of Functions often covered by Service Level Agreements (SLA)

Net Asset Value and Share Price calculation	• Timing of NAV release (including estimated NAVs) • Process for NAV sign-off (roles and responsibilities) • NAV and other reporting requirements • Valuation policy (particular reference to hard-to-value instruments and use of estimates) • Process for ensuring completeness and existence of positions (reconciliations of cash and positions, trade confirmations etc) • Sign off and notification of share price to external parties • Errors policy in place
Shareholder Services	• Subscriptions/Redemptions & Transfers ○ Accurate receipt of application/redemption instructions from investors in line with fund prospectus ○ Timely provision of subscription note/contract notes to investors ○ Reconciliation of cash transferred to/from the subscription/redemption account to/from the custody/trading accounts on a monthly basis ○ Timely payment of redemption monies in line with local regulatory requirements and fund prospectus • End Investor Servicing ○ Timely provision of investor statements containing holdings, latest NAV per share and market value of holding ○ Timely responses to investor/manager queries ○ Timely and accurate notification and process of corporate action ○ Money laundering – Ensure there are policies and procedures that meet or exceed requirements imposed by the anti-money laundering (AML) regulations set by their local regulator ○ Application of AML/know-your-customer (KYC) requirements in line with jurisdictional and prospectus requirements ○ Monitoring and reporting of suspicious activity • Regulatory Filings

	○ Completion and submission of statutory/listing filings as required (in conjunction with Corporate Secretary) • Monitoring ○ Employment retirement income security act (ERISA) and other investor tax requirements
Transaction Processing	• Ability to handle Security and FX trades • Ability to handle corporate actions • Definitions of accounting policies for interest and income accruals • Charges and expenses including performance fees • Subscriptions, redemptions and transfers – trade orders, order confirmation, trade confirmation • Cash management – cash balance review, cash movements • Reconciliations – when performed and detail of reconciliation • Monthly custodian reporting – reporting contents, for example, settled positions, latest prices, market value
Compliance	• Pricing control • Error and breach reporting
Accounting and Financial	• Accounting standards used • Filing or accounts
Corporate Secetrarial	• Maintenance of all statutory books and records • Provision of registered office facilities • Organisation of opening of subscription, holding, redemption, brokerage accounts as well as trading and any other bank accounts as required • Annual Reports and organisation of annual meetings and emergency general meetings • Arrangement execution of legal documents by fund directors • Submission of required information to relevant regulatory body

Appendix C: Examples of Compliance Procedures Designed to Identify, Detect and Prevent Market Abuse

Abuse	Procedure
Insider dealing	Notification to the compliance officer if an employee believes he/she has received inside information. Compliance officer to determine whether information is material and non-public. If information is material and non-public, the securities of the issuer concerned should be placed on the restricted list (in which case such stocks cannot be traded) or on a grey list (non-disclosed restricted list, which prevents such information from being shared with the entire firm such that it might allow personnel to second guess why something was restricted). Securities (shares, bonds, etc) of companies on the restricted list in which the entire firm would be excluded from dealing (e.g. restricted in the order management system). Where practicable, use of Chinese walls to prevent, for example, individual portfolio managers who are members of a creditors' committee of a distressed or bankrupt company (and who therefore have access to confidential information) from also trading such company's debt or equity.

	In instances where inside information is known to employees who have no active involvement in the investment management function, documentation of details of this knowledge should be placed on a separate (non-publicised) register.
Dissemination of inside information	Managers should have policies to restrict dissemination of material non-public information including, for example, the manager's own intention actively to engage with a company (e.g. by advocating/suggesting a corporate restructuring).
Non-disclosure of shareholdings when disclosure thresholds have been exceeded	Managers should document arrangements with other parties (e.g. other managers) together with which it has adopted a "lasting common policy towards the management of the issuer in question". Relevant disclosures should take place if disclosure thresholds are exceeded, accounting for collective share ownership of all parties involved.
Prevention of market manipulation	Public relations policies regarding public statements of intent to seek to ensure that no false or misleading impressions are given to the market.

Appendix D: Examples of Non-Binding Guidance to Determine "Similarity"

1)	The Portfolio Manager or investment team, the investment mandate (i.e., equity, fixed income, macro) and the strategy or style (i.e., market neutral, relative value, trend following) will all need to be the same.
2)	Additionally, the "similar" fund or separately managed account will have to have an 80% overlap in the following 4 areas (an example follows each item): a) **Asset classes traded** (i.e., mortgages, equity, credit, FX) - If the fund is 100% equities, then other funds/sleeves must have at least 80% in equities to be classified as similar. b) **Target risk and return** - Funds must have similar risk-return targets (measured by Sharpe or Information Ratio) to be classified as similar. Thus, if the fund targets a Sharpe ratio of 1, then "similar" funds must target a Sharpe between 0.8 and 1.2 (+/-20% band). c) **Time horizon of positions** - If the average holding period for the fund is 3 months, then the holding period for the similar fund needs to be between 2.4 to 3.6 months (+/- 20% band). d) **Average liquidity of positions** - If the average liquidity profile of the fund is 10 days, then the similar fund needs to have an average liquidity profile between 8 to 12 days to be classified as similar (+/- 20% band).
3)	A multi-strategy fund would have to have 80% overlap of allocations among sub-strategies, and the sub-strategies would have to be substantially similar (80%), as in item 2 above.