

HFSB Consultation Paper (CP3/2011) Internationalising and Strengthening the Hedge Fund Standards

The HFSB invites comments on this Consultation Paper 3/2011 (CP3/2011). Comments should be submitted by 28.10.2011. This CP contains a number of questions for respondents, which can be submitted electronically (Word, pdf-document) to Thomas.Deinet@hfsb.org. Alternatively, please send comments in writing to:

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CP3/2011
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It is the HFSB's policy to make all responses to consultations available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure.

Executive Summary

This Consultation Paper sets out a series of proposed amendments to the Hedge Fund Standards which are designed to achieve two things: to make the Standards more relevant internationally and to strengthen the Standards in the light of a number of issues that became apparent during the financial crisis.

The Standards were originally developed in the context of the UK regulatory environment and the principles-based approach followed by the UK regulator, the Financial Services Authority. Accordingly there are specific references to the FSA's "Principles for Businesses" in the Standards.

This approach was followed because the majority of hedge fund managers in Europe are based in the UK and were therefore familiar with the FSA's regulatory regime. However, as international interest in the Standards has grown, it has become clear that we need to modify the Standards to ensure that they are equally relevant to a broad international constituency and are not perceived as being tied to a particular national regulatory regime.

Ensuring that the Standards are appropriate for US managers is a particular focus of this Consultation Paper. About two-thirds of the global hedge fund industry is based in the United States. There is growing interest in the Standards from US managers and from leading international investors, a number of whom are represented on the Hedge Fund Standards Board or are members of the HFSB Investor Chapter.

The proposed amendments to the Standards relating to fund governance, in particular, have been designed specifically to cater for the different approach to hedge fund structuring that is typical in

the US. We are proposing, for example, that where a fund does not have an independent governing body in place to protect investors' interests, there should be an obligation to ask for investor approval before key actions may be taken which may involve a potential conflict of interest between the manager and investors.

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

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

This consultation therefore is part of a continuing, dynamic process to update and improve the Standards in the light of experience, which is an essential aspect of the HFSB's role.

The Standards were created with the aim of setting out good practice in the hedge fund industry to complement statutory rules and regulations. This is particularly the case in areas of complex or innovative practice, where Standards can often be a more effective way of influencing behaviours and achieving public policy aims than statutory rules. As custodian of the Standards, the HFSB is also responsible for updating them in light of changes in the environment and for responding to the needs of managers, the expectations of investors and public policy requirements.

1. Internationalisation of the Standards

The hedge fund industry is a global industry with an international investor base and the Standards need to reflect this. This consultation addresses those areas where the Standards were originally tailored to the UK market place. The amendments are designed to make the Standards more suitable for managers from other jurisdictions, notably the US.

1.1. Governance

The HFSB has always placed great importance on strong and independent fund governance as a mechanism for mitigating conflicts of interest that can arise both between managers and investors and between different investors. Where a fund governing body is in place consisting of highly-qualified, independent directors, who are capable of holding the manager to account for its performance and conduct under the investment management agreement, investors may feel comfortable having limited input into decision-making where conflicts of interest may be present.

However, the HFSB acknowledges that in practice governance approaches vary from jurisdiction to jurisdiction due to differing conventions or the use of fund structures (such as limited partnerships) which are not naturally conducive to independent governing bodies. As a result, it is not always possible to achieve the degree of independence investors might consider necessary in order to mitigate conflicts of interest. Therefore, in cases where no independent governing body is in place, investors will expect the fund documentation to contain more specific rules governing fund behaviour. For example, investors may want the right to approve certain key actions or to be given sufficient notice to redeem before such actions take effect. The proposed amendment to the Hedge Fund Standards therefore focuses on increasing investor confidence in governance procedures in those cases where no independent governing body is in place.

1.1.1 Proposed amendment- Standard 21: Fund governance Standards and Guidance

21.1 Prior to the establishment of a fund, a hedge fund manager should assess where the fund governance structure will lie on the “spectrum” (see above)¹. In the light of that assessment, the manager should be proactive in seeking to ensure that a fund governance structure which is suitable and robust to oversee and handle potential conflicts of interest is put in place at the outset.

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

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

¹ Refers to introductory section of the Governance chapter – see amendments to this introduction and the definition of the “spectrum” in the main document with the Standards (section D).

hedge fund manager.

21.2 Where a majority of the individual members of the fund governing body are not independent of the manager or where there is no fund governing body, certain key actions, such as material changes to the fund's commercial terms, investment strategy, or legal structure (except changes that are unambiguously beneficial to investors or their investments in the fund) should 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 providing advance notice sufficient for investors to redeem before such actions take effect.

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

...

1.1.2 Consultation question

Q1 Do you agree that where the fund governing body is not sufficiently independent, this proposed approach would help mitigate conflicts of interest between investors and managers? If you disagree, please elaborate.

1.2 Removing explicit anchoring in the FSA principles

The Standards were originally based on the FSA's "Principles for Businesses" and principle-based approach to regulation. However, the growing international base of signatories and investors has increased the need to make the Standards more international and to avoid the Standards being perceived as tied to a particular national regulatory regime.

The proposed amendments are "cosmetic" in nature in that they simply involve deletion of any specific references to the FSA principles in the Standards. The substance of the Standards remains unchanged (see separate document with the proposed new Standards in comparison to the original version available at http://www.hfsb.org/files/final_standards_21_jan.pdf, where a dedicated section on the relevant FSA principles had been included).

Q2: Are there any objections to deleting references to the FSA's Principles for Businesses from the text of the Standards?

1.3 Review of legal wording

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

- the Standards cannot give the manager a responsibility he legally does not have;
- the fund governing body is legally independent and separate from the manager and the manager is not able to control the governing body's actions; and
- specifically in the UK context: if a manager were to exercise central management and control with respect to a fund (in place of its offshore governing body), the fund may be treated as UK tax resident.

At present, this wording is included in many of the Standards. There are two problems with this: (a) it makes the text unwieldy and cumbersome and (b) the wording appears to weaken the substance of the Standards.

1.3.1 Approach to address this

There are different ways to address this:

One solution simply would be to remove the wording in question. However, this then would imply that the manager can indeed control the actions of the fund governing body, which is not the case.

Alternatively, one could introduce the passive voice, stating the desired outcome to be achieved rather than stating what action the manager/and or fund governing body is required to take to achieve that outcome.

Example:

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

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

In order to clarify the distinction between the manager and the fund governing body, the following explanation would be included in the introduction to the Standards:

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

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

1.3.2. Proposed amendments

This amendment affects the following Standards:

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

(see separate document with all the relevant amendments in track changes²)

1.3.3 Consultation questions

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

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

² <http://www.hfsb.org/?page=11474>

2. Strengthening Investor Disclosure

Investor disclosure is a key component of the HFSB framework. The proposed improvements to investor disclosure affect the following areas:

- Investment policy and risk disclosure
- Commercial terms disclosure
- Policies to prevent market abuse.

2.1. Investment policy and risk disclosure

Failure to understand and manage risk was the principal cause of the recent financial crisis. While the systemic dimension of the crisis was caused by excessive risk taking by banks, it is widely accepted that better risk management is needed across many areas of the financial markets in order to reduce both the likelihood of a future crisis and the scale of future misallocations of capital.

Understanding the investment strategies employed by hedge funds and the associated risks is a key part of initial investor due diligence and the continuing monitoring of hedge fund investments.

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

2.1.1 Proposed amendments – Standard 1: Investment policy and risk disclosure

1.1 ~~A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to include a~~ An appropriate level of disclosure (taking into account the identity and sophistication of potential investors) and explanation in the fund's offering documents of the fund's investment policy/strategy, process, guidelines and associated risks should be included in the fund's offering documents.³

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

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

³ See introduction, chapter 1.3 of the actual Hedge Fund Standards: The fund versus the manager

- general details of the investments and instruments (including, for example, derivatives) likely to be included in the fund's portfolio;
- details of any investment restrictions or guidelines and of the procedures the manager will follow in respect of any breaches;
- details of the investment process, including internal reviews and controls; and
- an explanation of the circumstances in which the fund may use leverage, the sources of such leverage, ~~and~~ details of any restrictions on the use of leverage, and an explanation of how the manager defines leverage and/or net exposure levels.

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

- the target return for the strategy, if applicable;
- the level of risk for the strategy;
- the historical track record of the strategy, if applicable;
- upon request, the aggregate value of assets managed by the manager using the same investment strategy; and
- the manager's "soft-dollar" policy or "use of dealing commissions" policy and practices.

...

~~1.3 A hedge fund manager should consider carefully the appropriate mechanism, given the nature of potential investors, for changing the fund's stated investment policy/strategy and advise the fund governing body accordingly. This may range from prior investor/fund governing body consent to consultation to mere notification. Once the fund governing body has determined the appropriate mechanism, the manager should do what it reasonably can to enable and encourage the fund governing body to disclose such mechanism appropriately in the fund's offering documents. No change to the investment policy, 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, or (b) providing advance notice sufficient for investors to redeem prior to the effective date of the changes without penalty.~~

...

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

The HFSB envisages that, amongst other things, such disclosure would 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 staff changes, new or terminated funds, or changes to any key service providers.

1.6 Upon reasonable request, a manager should (unless 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 litigation in which it is involved (other than proceedings which the manager considers to have been brought frivolously or vexatiously) and (b) any formal regulatory enforcement proceedings against it.

- For these purposes, the HFSB considers by way of example, that in the U.K., the appointment of “specific” investigators under section 168 of FSMA, or the appointment of investigators to assist overseas regulators under section 169 of FSMA; and in the U.S., commencement of a formal inquiry by the Enforcement Division of the SEC or any action which would be required to be disclosed under Item 11 of SEC Form ADV (Part 1A) or CFTC Rules 4.34(k)(1) or 4.24(l)(1) (or the equivalents in jurisdictions outside the UK or US, as appropriate) would constitute “formal” regulatory enforcement proceedings.
- The HFSB considers that the appointment of “general” investigators under section 167 of FSMA or a request for information as part of a thematic review or otherwise pursuant to sections 165 or 165A of FSMA or a notice requiring the provisions of a report under section 166 of FSMA (or the equivalents in jurisdictions outside the UK) would not constitute “formal” regulatory enforcement proceedings.
- The HFSB considers that a routine exam 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.

2.1.2 Consultation question

Q5 Do you agree with the proposed improvements on disclosure in Standard 1.1? If not, please explain.

Q6 Do you agree with the approach for investor involvement in the context of material changes to the investment policy (1.3)? If not, please explain.

Q7 The Standard refers to the provisions relating to shareholder voting/consent/approvals contained in the fund’s constitution: Is it necessary to specify these provisions in more detail (1.3)?

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

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

2.2. Commercial terms disclosure

The commercial terms of hedge funds include fees and expenses, and “lock-up” periods, as well as fair treatment of investors in situations of distress (e.g. illiquidity in the fund) and the relevant procedures when changes are made to the commercial terms of a fund. This consultation focuses on improving the disclosure of fees and expenses, handling of changes to commercial terms, and fair treatment of investors in relation to parallel funds and accounts.

2.2.1 Fees and expenses disclosure

Additional guidance has been suggested to increase transparency on material fees, costs and charges which will be payable by the fund. Until now, the Standards required disclosure of fees and

expenses payable to the manager and service providers by the fund. A new provision requiring disclosure of other material fees, expenses, cost and charges payable by the fund is proposed (see **guidance to Standard 2.1** below). It is also proposed that **Standard 2.5**, which relates to disclosure in the fund's financial statements, be broadened to include not only disclosure of management and performance fees, but also any other fees and expenses charged to the fund.

2.2.2 Changes to commercial terms

From an investor perspective, it is crucial that material changes to commercial terms are reported in advance; they should either require investor consent or allow investors to redeem without penalty prior to the effective date of the changes. This has been clarified in **Standard 2.2** (see below).

2.2.3 Fair treatment in relation to parallel accounts/funds

The redemption crisis in 2008 and 2009 has brought the issue of fair treatment of investors to the forefront of the debate. In this context, the handling of redemption requests and the existence of side letters containing material terms (e.g. in relation to redemption rights) have been scrutinised thoroughly by investors.

Many of these issues had already to some extent been addressed by the Standards (e.g. disclosure of the existence of side letters and the nature of material terms included in them). The HFSB addressed further concerns in relation to the handling of redemptions in its consultation CP1/2009⁴. However, the focus of those amendments was on conflicts arising between investors in the same fund.

This consultation focuses on parallel funds and managed accounts using the same investment strategy as the main fund and where the terms of such parallel accounts/funds can have a material adverse effect on investors in the main fund.

Potential scenario:

- The main fund imposes a significant lock-up on investors, while a separate account/fund does not restrict an investor's ability to redeem its investment.
- Where disposal of underlying assets by the parallel account/fund has significant market impact on the price of the assets (e.g. where the parallel account/fund is significant in size compared to the main fund or the underlying market liquidity is low, e.g. in times of liquidity distress), investors in the main fund might be concerned about being disadvantaged vis à vis investors in the parallel account/fund.

The **newly introduced Standard 2.4** seeks to address this issue by asking for better investor disclosure of the existence of parallel funds or accounts, as well as any material adverse effects which such other funds or accounts might have on investors in the fund.

⁴ <http://www.hfsb.org/?page=11474>

2.2.4 Proposed amendments - Standard 2: Commercial terms disclosure

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

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

- fees and expenses:
 - fair disclosure of the methodology used to calculate performance fees;
 - details of any other remuneration received by the manager in connection with its management of the fund (this will be relevant, for example, where a hedge fund is a “feeder” fund into another fund managed by the same manager);
 - the basis of calculation for any base management fee and details of the nature of any expenses which may be payable or reimbursed by the fund to the manager;
 - to the extent possible, the amount of, and/or method of calculating, the periodic fees payable to the fund's other service providers;
 - to the extent known, details of other material fees, costs and charges which will be payable by the fund; and,
 - if applicable, the fact that the fees and expenses payable to service providers may change.

...

2.2 ~~A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to disclose any material changes to such commercial terms to investors~~ Changes to such commercial terms that the fund governing body considers to be materially adverse to investors should not be effected without either (a) obtaining investor consent in accordance with the provisions relating to shareholder voting/consent/approvals contained in the fund's constitution, or (b) providing advance notice sufficient for investors to redeem prior to the effective date of the changes without penalty.⁵

2.3 A hedge fund manager should disclose the existence of side letters which contain "material terms"⁶, and the nature of such terms. A hedge fund manager is not required to disclose the existence of side letters which contain no material terms.

Further guidance on this Standard is contained in AIMA's Industry Guidance Note on Side

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

⁶ “Any term the effect of which might reasonably be expected to be to provide an investor with more favourable treatment than other holders of the same class of share or interest which enhances that investor's ability either (i) to redeem shares or interests of that class, or (ii) to make a determination as to whether to redeem shares or interests of that class, and which in either case might, therefore, reasonably be expected to put other holders of shares or interests of that class who are in the same position at a material disadvantage in connection with the exercise of their redemptions rights.”

Letters.⁷

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

~~2.5 A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to disclose in the fund's financial statements the~~The fees and expenses (including but not limited to management and performance fees) charged to the fund should be disclosed in the fund's financial statements. This includes explanations in the annual report which allow investors to compare, readily, the fees and expenses charged with the description of such fees and expenses set out in the fund's offering documents where this is not obvious from the disclosure in the financial statements.⁸

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

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

2.2.5 Consultation questions

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

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

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

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

2.3 Policies to prevent market abuse

Proper market conduct and prevention of market abuse are crucial to maintaining market integrity and overall confidence in financial markets. Market participants must comply with relevant law and regulation applicable to the markets in which they invest. However, not all managers operate in such tightly regulated environments. Therefore, the HFSB proposes that an unregulated manager should make a summary of its prevention of market abuse policy available to investors upon request.

⁷ AIMA's Industry Guidance Note on Side Letters and Supplement No. 1 thereto:
<http://www.aima.org/uploads/AIMAIndustryguidanceNoteSideLettersMembers.pdf>

⁸ See introduction, chapter 1.3 of the actual Hedge Fund Standards: The fund versus the manager

Proposed amendments – Standard 24: Prevention of market abuse

24.1 A hedge fund manager should disclose to investors in its own marketing materials that it has a policy to prevent market abuse ~~(no disclosure of the actual policy is required)~~. For managers that are not regulated, a summary of the policy should be made available to investors upon request.

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

3. Consistency in Valuation Disclosure

Understanding the valuations applied to the fund’s assets is not only important to the hedge fund managers themselves but also to hedge fund investors, who need to assess the reliability of valuations and the liquidity of their investments within the context of their own valuation and risk management requirements. The Hedge Fund Standards always have promoted strong liquidity risk management practices for hedge fund managers. The Hedge Fund Standards have also required disclosure to investors of the liquidity profile of the fund (e.g. disclosure of the percentage of assets that the manager considers hard to value). In recent years the accounting profession has made significant progress in defining approaches to the categorisation of assets from this perspective. Both the Financial Accounting Standards (FAS) and International Financial Reporting Standards (IFRS) have developed such definitions and approaches.

- *Statement of Financial Accounting Standards No. 157 (FAS 157)[also known as ASC 820 in the updated FASB codification] is an accounting standard issued by the Financial Accounting Standards Board (FASB) and became effective for fiscal years beginning after November 15, 2007. It includes a fair value hierarchy, ranking the reliability of information used to determine fair values.*

Illustration of fair value hierarchy:

Level 1	<i>Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets. (Examples: listed equities, government securities, money market securities ...)</i>
Level 2	<i>Inputs to the valuation methodology include:</i> <ul style="list-style-type: none"> • <i>Quoted prices for similar assets or liabilities in active markets;</i> • <i>Quoted prices for identical or similar assets or liabilities in inactive markets;</i> • <i>Inputs other than quoted prices that are observable for the asset or liability;</i> • <i>Inputs that are derived principally from or corroborated by observable market data by correlation or other means.</i> <i>(Examples: Corporate bonds, MBS, certain OTC derivatives)</i>
Level 3	<i>Inputs to the valuation methodology are unobservable and significant to the fair value measurement. (Examples: private equity, distressed debt, exotic derivatives)</i>

- *International Financial Reporting Standard 7 (IFRS 7) is a reporting standard set by the IFRS Foundation. It became effective on 1 January 2007 and has been amended several times since. It includes a fair value hierarchy, consisting of 3 levels of inputs:*

Level 1	<i>Quoted prices for similar instruments</i>
Level 2	<i>Directly observable market inputs other than Level 1 inputs</i>
Level 3	<i>Inputs not based on observable market data</i>

3.1 Proposed amendments (Standards 7 and 8 - Hard to value assets- Disclosure Standards and Guidance)

The purpose of the amendment is to enable better understanding by investors of valuations and the liquidity characteristics of the fund’s portfolio. The approach being proposed is to use generally accepted definitions to improve understanding and comparability while focusing on “Level 3” assets.

Proposed amendments – Standard 7: Hard-to-value assets – Governance Standards and Guidance

7.1 Where a hedge fund manager performs **in-house** valuations of ~~what it considers to be~~ hard-to-value assets **(i.e., Level III assets as defined by ASC 820⁹ or IFRS 7) in-house** or is otherwise involved in providing final prices to the valuation service provider, ~~it should do what it reasonably can to enable and encourage the fund governing body to adopt~~ valuation procedures for such assets which are aimed at ensuring a consistent approach to determining fair value **should be adopted** and ~~ensure that~~ such procedures ~~are~~ **should be** set out in the Valuation Policy Document.¹⁰

...

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

8.1 A hedge fund manager should disclose periodically the percentage of the fund's portfolio that **falls into each of the three “levels” prescribed by ASC 820¹¹ or IFRS 7 is invested in what the manager considers to be hard-to-value assets** (e.g. via newsletters) and, where meaningful and applicable, the extent to which internal pricing models or assumptions are used to value certain components of the fund’s portfolio invested in hard-to-value assets.

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

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

3.2 Consultation questions

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

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

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

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

⁹ Formerly FAS 157

¹⁰ See introduction, chapter 1.3 of the actual Hedge Fund Standards: The fund versus the manager

¹¹ Formerly FAS 157

4. Strengthening Risk Management

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

4.1. Operational risk- strengthening fraud prevention

Preventing fraud and financial crime has always been a core component of the HFSB's Operational Risk Standards. In order to strengthen the approach to preventing misappropriation of client monies, a new Standard is proposed covering internal controls where client money is controlled by the manager. This had been included previously in Standard 17c.1 as guidance.

Proposed amendment Standard 17c: Fraud and financial crime prevention

17c.1 A hedge fund manager should be confident that it understands the applicable laws and regulations in the markets in which it deals and has effective systems and controls in place to enable it to identify, assess, monitor and manage the risk that ~~it is the hedge fund manager might be~~ used to further financial crimes.

This may apply to areas such as:

- anti-money laundering procedures¹² (although typically the fund's administrator will be responsible for compliance); ~~and~~
- procedures to prevent market abuse offences (see also Standard [23] (*Prevention of market abuse*)).; ~~and~~
- ~~strict internal controls to prevent misappropriation of client money (e.g. co-signing policies), where client money is held by the manager.~~

...

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

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

4.2. Operational risk - personal dealing

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

¹² Further guidance on Anti-Money Laundering Regulations can be found in AIMA's Guide to Sound Practices for European Hedge Fund Managers (2007), (section 4.1.5).

Operational risk – governance standard and guidance [17a]

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

Operational risk – personal account dealing [17h]

17h.1 A hedge fund manager should adopt a personal account dealing policy for its staff, ensure awareness of this policy, test compliance from time to time and, where a manager is not regulated, make a summary of the policy available to investors upon request.

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

4.3 Outsourcing risk

The hedge fund industry is largely based on an unbundled business model with managers focusing on what they are best at - managing the portfolio - with third parties providing other services, such as administration, prime brokerage, etc. While structural independence in many of these areas is generally considered beneficial (see consultation CP2/2009 on independent administration), outsourcing introduces new risks and these service providers therefore need to be carefully selected and monitored.

In relation to outsourcing risk, the Hedge Fund Standards have focussed mainly on valuation, fund administration, prime brokerage and auditing. The proposed amendments seek to improve supervision of fund administration by the manager. The Hedge Fund Standards now explicitly mention monitoring and reporting of issues in relation to the quality of such services to the fund governing body.

Outsourcing risk - Governance Standards and Guidance [19]

...

Valuation and administration

...

~~19.4 A hedge fund managers should do what it reasonably can to enable and encourage the fund governing body to review~~ The services provided by the relevant service provider should be reviewed and monitored against contractual or other agreed standards.¹³

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

...

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

¹³ See introduction, chapter 1.3 of the actual Hedge Fund Standards: The fund versus the manager