

Consultation Paper CP4/2015: Conflicts of interest



The Hedge Fund Standards Board (HFSB) invites comments on this Consultation Paper CP4/2015. Comments should be submitted by 12 June 2015 electronically (Word, pdf-document) to thomas.deinet@hfsb.org or by post to:

Hedge Fund Standards Board
CP4/2015
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Executive Summary

This consultation paper outlines a number of proposed amendments to the Hedge Fund Standards which are intended to achieve three things: (i) investor disclosure of similar funds, accounts and vehicles including employee/partner co-investment, (ii) investor disclosure of trade allocation policies and (iii) sound internal arrangements to mitigate conflicts of interest.

The proposals set forth in this consultation paper have been developed by an international working group of managers and investors put together by the HFSB to help improve the management and disclosure of conflicts of interest.¹ The proposal builds on the existing Standards and takes into account the existing regulation.

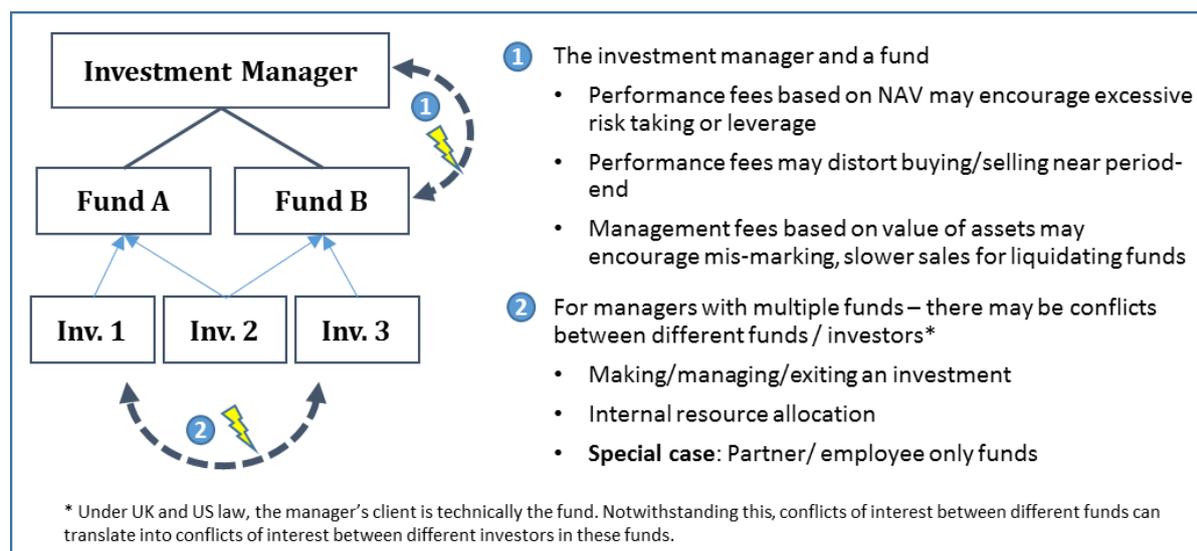
This consultation is part of the HFSB's mandate to update and improve the Hedge Fund Standards, responding to the needs of managers, investors and public policy requirements. The Hedge Fund Standards complement the statutory rules and regulations in areas of complex and innovative practice, where standards can be a more effective way of influencing behaviours and achieving public policy aims than statutory rules.

1. Introduction

Asset managers act as agents for their clients and must act in their clients' best interests and treat them fairly. This principal – agent relationship between managers and their clients can give rise to conflicts of interest. They can arise between a manager and its clients and between different clients (see Exhibit 1) and are usually caused by information asymmetries or lack of alignment.

¹ See Appendix A for the list of working group participants

Exhibit 1: Overview of types of conflicts of interest



The recent HFSB discussions with institutional investors revealed some investor concerns about lack of adequate disclosure of conflicts of interest by some managers in relation to parallel/competing funds, as well as about the lack of alignment of interest between managers and investors. This has prompted the HFSB to review the Hedge Fund Standards and Guidance, existing rules and regulation, as well as current industry practice, to see how the appropriate Standards can be strengthened and/or new ones added.

None of the issues highlighted in this consultation paper are unique to hedge fund managers. In fact, they can arise across the entire spectrum of the asset management industry; therefore, the conclusions drawn from this consultation process will have broader applicability to all asset management firms.

2. Specific investor concerns

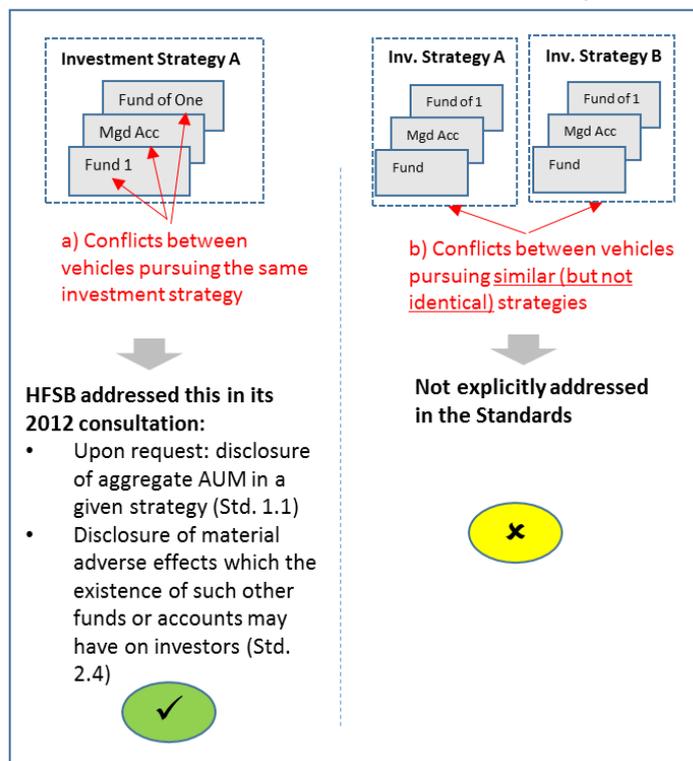
The area brought to the attention of the HFSB is a conflict that can arise between parallel funds, as well between external funds and partner/employee only funds, in each case where the funds pursue similar (but not necessarily identical) investment strategies. Investors highlighted specific concerns about priority of transactions/opportunities (where funds compete with respect to individual investments), manager resource allocation to different funds/accounts/vehicles and alignment of interests between the investment manager and the investors.

The Hedge Fund Standards currently recommend that investors should assess conflicts that can arise between funds or accounts pursuing the same investment strategy. However, the Standards do not explicitly capture funds or accounts pursuing **similar (but not identical)** strategies (see Exhibit 2).

Many existing practices seek to address these concerns by putting in place processes to detect and mitigate conflicts of interest as part of the manager’s compliance programme, segregating the responsibilities in compliance and valuation, introducing trade allocation policies, fund governance arrangements etc.

Existing rules and regulations address these concerns (see section 3) by focussing on prioritising client interests and management/mitigation of conflicts of interest. However, the existence of regulation alone may not be a sufficient safeguard. This means, in practice, that investors play a critical role in scrutinising managers and assessing any conflict of interest in their due diligence in order to be comfortable with how conflicts are addressed. Manager disclosure plays an important role in enabling this due diligence.

Exhibit 2: Conflicts of interest between different funds/accounts



3. What do regulations and the Hedge Fund Standards say?

Financial regulators are well aware of conflicts of interest that can arise in investment management. Accordingly, a large body of regulation exists to address conflicts. Regulatory approaches vary from jurisdiction to jurisdiction, but the overarching objective is to ensure fair treatment of investors by either managing/mitigating conflicts of interest or disclosing such conflicts, where applicable. Appendix C provides an overview of the regulatory focus on conflicts of interest for different jurisdictions.

In addition, lately many regulators have paid particular attention to identifying conflicts of interest between asset managers and their investors. For example, the recent regulatory compliance inspections by the SEC Office of Compliance Inspections and Examinations (OCIE) started assessing the handling of conflicts of interest by registered firms. The UK FCA published a dedicated review of conflicts of interest in asset managers in 2012.

The Hedge Fund Standards provide a comprehensive framework for addressing conflicts of interest in key areas relevant to hedge fund management, including risk management, valuation, commercial terms and governance.

Exhibit 3: Examples for conflicts of interest addressed by the Hedge Fund Standards²

Conflicts of interest	Mitigation (examples)
Management fees based on value of assets might	<ul style="list-style-type: none"> • Independent valuation / segregation of functions • Governance framework for valuing hard-to-value assets Valuation Policy • Investor disclosure • Review by fund directors

² Appendix B contains additional examples of how the Standards address different conflicts of interest.

Conflicts of interest	Mitigation (examples)
encourage over-valuation	<i>(Standards 5-9, 21)</i>
Performance fees based on NAV might encourage excessive risk taking or leverage by the manager ('roll the dice')	<ul style="list-style-type: none"> • Upfront risk disclosure (including use of leverage) • Risk management framework • Ongoing risk reporting to investors • Independent fund governance arrangements / review of adherence to investment policy <i>(Standards 1, 9-16, 21-22)</i>
Hidden fees charged to the fund	<ul style="list-style-type: none"> • Detailed upfront commercial terms disclosure • Comparability of fee methodology in offering document and financial statements • Standards addressing adverse changes of commercial terms <i>(Standard 2)</i>
Conflicts of interest between different investors	<ul style="list-style-type: none"> • Handling of redemptions / fair treatment of investors • Disclosure of existence of material side letters • Disclosure of existence of funds/accounts using the same investment strategy (as the investor fund) and potential material adverse effects <i>(Standard 1, 2)</i>
Personal account dealing	<ul style="list-style-type: none"> • Personal account dealing policy (including disclosure to investors upon request) <i>(Standard 17h)</i>

In addition to the examples above, the HFSB recently published the [Standardised Board Agenda](#)³ which highlights the areas where fund directors play an important role in assessing and mitigating conflicts of interest.

4. Proposed amendments to the Standards

While regulations in this area can provide some level of comfort, investors should assess conflicts of interest as part of their due diligence. The Hedge Fund Standards complement existing regulations and aim to help investors in their due diligence process by focusing on increasing disclosure to enable better investment decisions.

The proposed amendments consist of three distinct components:

- 1.) Disclosure of similar funds, accounts or vehicles, including partner/employee funds (upon request)
- 2.) Disclosure of trade allocation policy to investors (upon request)
- 3.) Internal arrangements to mitigate conflicts of interest.

The proposed amendments partly build on the existing standards introduced in 2012, requiring better investor disclosure of the existence of parallel funds, accounts or vehicles, as well as the material adverse effects which such funds or accounts might have on investors in the fund (Standard 2.4) and (upon request) the disclosure of the aggregate value of assets managed by the manager using the same investment strategy (guidance under Standard 1.1).

³ See <http://www.hfsb.org/?section=12762>

1.) Disclosure of similar funds, accounts or vehicles, including partner/employee funds

At present, the standards require disclosure of the existence of parallel funds (including aggregate assets under management) pursuing the same strategy to allow investors to assess their investment in the context of the overall allocation to the strategy.⁴ However, this can be understood narrowly as referring only to funds or accounts which are **identical** and not explicitly addressing situations where funds/accounts are not identical but where there is sufficient overlap to create a potential conflict of interest.

The proposed amendments achieve the following:

- Widening the scope by referring to “similar” investment strategies rather than just strategies that are the “same” (see separate discussion of the definition of “similar” below)
- Providing transparency around the co-investment of partners/employees in the strategy
- Disclosure of the existence of partner/employee only funds (and their aggregate size)

Exhibit 4: Proposed amendments to Standard 2.4 [Commercial Terms Disclosure] (Track changes in red compare to the existing Standard)

Upon request, disclosure of [under Standard 2.4] :

- a) Existence of ~~parallel funds~~, ~~or~~ accounts **or vehicles** managed by it using the same **or similar¹** investment strategy,²
- b) any material adverse effects which the existence of such other funds, ~~or~~ accounts **or vehicles** may have on investors in the fund,
- c) the aggregate value of assets managed by the manager using the same **or similar¹** investment strategy,
- d) **the aggregate size of employee or partner interests in the investment strategy,³**
- e) **the existence of any other funds or accounts managed by it which follow the same or similar¹ investment strategy to the fund and which are available for investment only by partners or employees (or their connected persons) of the hedge fund manager,^{2,4} and**
- f) **in the case of (e) above, the size of such funds or accounts.³**

Footnotes:

1 [See separate definition of “similar” in the next section below]

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

3 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.

4 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.

Definition of “similar”

One challenge is to define what constitutes a “similar” strategy (footnote 1). On the one hand, it is not intended to capture funds/accounts which have some identical underlying positions but which do not trade in parallel—it would be very difficult for managers to implement and monitor this

⁴ See HFSB consultation paper CP3 p. 10 (Fair treatment in relation to parallel accounts/funds) http://www.hfsb.org/sites/10377/files/consultation_document_cp3_04_august_2011.pdf

situation. On the other hand, it is important to capture, for example, a multi-strategy set-up, where a fund is similar in relation to a sub-strategy of such multi-strategy fund, in particular in situations where trades might have scarce capacity.

The working group came up with a number of different definitions for “similar”, which are included in Exhibit 5.

Exhibit 5: Overview possible definitions of “similar strategies”

Footnote 1: Similar strategies should be interpreted to include funds, accounts or vehicles managed by an investment management team or individual within the hedge fund manager and which trade <u>substantially</u> in parallel...		
... with the fund/account/vehicle or, in the case of a multi-strategy fund, with one or more sub-strategies of the fund.	... 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).	... in whole or for some sub-strategies with the target fund or are part of the same trade allocation approach.
(i)	(ii)	(iii)

Consultation questions:

- 1.) Do you agree with the approach to widening the scope of the same / similar strategies? If not, please explain.
- 2.) Do you agree with the disclosure of aggregate (net) assets managed by the manager, or should disclosure include net and gross assets under management (AUM)?
- 3.) Which of the proposed definitions of “similar” (see **i, ii, iii** above) best captures potential conflicts of interests? Are there any suggestions for improvement (e.g. providing examples as guidance)?
- 4.) Do you agree with the proposed approach to disclosure of employee/partner funds? If not, please explain.
- 5.) It is common practice for managers to disclose aggregate firm AUM: Is there a need for a separate Standard requiring disclosure of all funds/accounts/vehicles (aggregated by strategy) to enable better investor due diligence of how firms allocate internal resources to different strategies?

2.) Disclosure of trade allocation policy to investors (upon request)

The manner in which asset managers allocate investments among clients has been a high priority item for regulators for many years. It is now common practice (and often a regulatory requirement) to put in place a trade allocation policy. From an investor perspective, the trade allocation policy is an important source of information to assess a manager’s allocation practices and also to detect potential conflicts. The proposed Standard requires the disclosure of the trade allocation policy to investors (upon request).

Exhibit 6: Proposed new Standards [Operational risk]

- 17i.1 A manager should put in place a trade allocation policy.**
- 17i.2 Upon request, a manager should disclose the trade allocation policy to investors.**

Consultation question:

6.) Do you agree with the proposed standard, including disclosure of the trade allocation policy to investors (upon request)? If not, please explain.

3.) Internal arrangements to mitigate conflicts of interest

Regulations in many jurisdictions cover conflicts of interest with varying levels of detail. For example, the European UCITS and AIFM Directives have detailed requirements to identify, manage, monitor and, where applicable, disclose conflicts of interest. In the US, Form ADV highlights a manager's fiduciary duties and requires full disclosure of all material conflicts of interests that could affect the advisory relationship. Managers who comply with such regulations most likely will comply with the proposed Standard below.

Exhibit 7: Proposed new Standard [Operational risk]

17k.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.

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

Consultation question:

7.) Do you agree with the proposed standard? If not, please explain.

Appendix A: Working Group participants and other contributors

(Individuals participated in a private capacity, representing their own views)

Name	Title	Organisation
Tom Dunn	Managing Principal	New Holland Capital
Adam Feild	Principal	New Holland Capital
Christophe Juhem	Executive Director, Head of Operational & Legal Due Diligence	Unigestion
Jennifer L. Keeney	Senior Risk Officer – Alternatives, Due Diligence Team	Russell Investments
Jon May	General Counsel	Marshall Wace
Toby Miller	Analyst – Operational Due Diligence	Aberdeen Asset Management
Moana Moore	Head of Compliance	CQS
Greg O'Connor	Global Head of Corporate, Policy and Regulation	Man Group
John Richardson	COO and General Counsel	IONIC Capital Management
Hannah Schneider	Founder	Regent's Compliance
Dan Stern	Co-CEO	Reservoir Capital Group
Riva Waller	COO	ISAM

Appendix B: Specific concerns addressed by the Hedge Fund Standards

Area	Standard	Approach
Total strategy AUM	1.1	Disclosure of aggregate value of assets managed by the manager using the same investment strategy (to address concerns about competing similar funds).
Changes to investment strategy	1.3	Either investor consent or ability to redeem before changes to investment strategy take effect.
Fees and expenses	2.1, 2.5	Disclosure of fees/expenses, other remuneration received by the manager, other fees payable by the fund, consistency between offering document and audited financial statements.
Changes to fees and expenses	2.2	Either investor consent or ability to redeem before changes to fees that are materially adverse to investors take effect.
Side letters	2.3	Disclosure of existence of side letters to investors which contain material terms and the nature of such terms.
Conflicts between different funds	2.4	Disclosure of existence of other funds/accounts using the same strategy / any material adverse effects they have (upon request).
Handling of redemptions, exit terms	2.1	Disclosure of exit terms (including indication of circumstances in which normal redemption mechanics might not apply or may be suspended).
Valuation of assets	5, 6	Segregation of functions, valuation policy, governance arrangements, investor disclosure of manager involvement in valuation process.
Risk management	9 – 16	Risk framework, segregation of functions, investor disclosure.
Operational risk management	17-18	Segregation of functions (compliance, risk management, valuation), separate reporting lines, remuneration incentives, personal account dealing policy (including disclosure of summary upon request)
Fund governance	21	Review of manager adherence to investment policy, review/approval of side letters, Disclosure of conflicts of interest of directors,

Appendix C: Regulatory focus on conflicts of interest

(Underlined words are hyper-linked to the relevant regulatory documents)

US Securities and Exchange Commission (SEC): Form ADV (Instructions for Part 2)	<i>Disclosure obligation as a fiduciary: (...) As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your clients that could affect the advisory relationship. (...) provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest (...), and can give informed consent to such conflicts or practices or reject them.</i>
US SEC Examination Priorities for 2014	<i>"Registrants [have engaged] in activity that puts their own interests ahead of their clients in contravention of their fiduciary duty and existing laws, rules and regulations." (p.4)</i>
European Securities and Markets Authority (ESMA): Alternative Investment Fund Managers Directive (AIFM-D)	<i>(80) ... to take all reasonable steps to avoid conflicts of interest and, where such conflicts cannot be avoided, to identify, manage and monitor, and where applicable, disclose, those conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors and to ensure that the AIFs they manage are fairly treated.</i>
UK Financial Conduct Authority (FCA): Principles 6 & 8	6) A firm must pay due regard to the interests of its customers and treat them fairly. 7) A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
UK FCA: Handbook	<ul style="list-style-type: none"> ▪ Investment Funds Sourcebook (e.g. FUND 3.2, 3.7, 3.9, 3.10, 3.11) ▪ Other: Conduct of Business Sourcebook (COBS 11.3.1 (3)), Senior Management Arrangements, Systems and Controls (SYSC 10.1)
UK FCA Report (2012)	<ul style="list-style-type: none"> ▪ Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks
Hong Kong Securities and Futures Commission (SFC)	<ul style="list-style-type: none"> ▪ Code of Conduct: GP6 (Conflicts of Interest) – avoid conflicts, treat clients fairly; paragraph 10.1 (Disclosure and Fair Treatment) ▪ Fund Manager Code of Conduct: 2.1.1-2.1.4 Personal Account Dealing; 2.2. Receipt of Provisions of Benefits
Monetary Authority of Singapore (MAS)	<ul style="list-style-type: none"> ▪ Securities and Futures Regulation (SFR): Regulation 13B ▪ Securities and Futures Act: Guidelines on Licencing, Registration and Conduct of Business for Fund Management Companies: Measures to mitigate conflicts of interest, disclosure (4.1.3)
Australian Securities and Investment Commission (ASIC):	<ul style="list-style-type: none"> ▪ Registered Managed Investment Schemes: Guidance on conflicts of interest (guide 76), specific disclosure duties (s601FD, 601FE) of the Corporations Act ▪ Unregistered Schemes: no requirements specific to conflicts of interest, but general Australian Trust law is applicable, separate guidance about corporate governance
Canadian National Instrument (31-103)	<ul style="list-style-type: none"> ▪ Identification of conflicts of interest (13.4), restrictions on managed account transactions (13.5), Disclosure of recommendation of related securities (13.6), relationship disclosure information (14.2), disclosure about fair allocation of investment opportunities (14.3); Companion Policy 31-103 CP 13.4-13.6, 14.2-14.4
Switzerland	<ul style="list-style-type: none"> ▪ Swiss Funds & Asset Management Association: SFAMA Code of Conduct: (5., 10.) Avoidance / disclosure of conflicts of interest [The Swiss Financial Market and Supervisory Authority FINMA has recognised the SFAMA Code of Conduct as a minimum standard]