



HFSB Consultation Paper (CP2/2009): Administration and Safekeeping

1. Overview

The HFSB invites comments on this Consultation Paper 2/2009 (CP2/2009). Comments should be submitted by **18 September 2009**. 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:

Hedge Fund Standards Board
CP2/2009 (Administration)
2nd Floor
167 Fleet Street
London EC4A 2EA

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.

Copies of this CP are downloadable from the HFSB website, www.hfsb.org.

2. Introduction

Recent market events such as the Madoff scandal have highlighted the importance of independent oversight in areas such as prime brokerage, NAV calculation, cash management and transfer agency. These activities (except for prime brokerage) are often subsumed under the term fund administration.

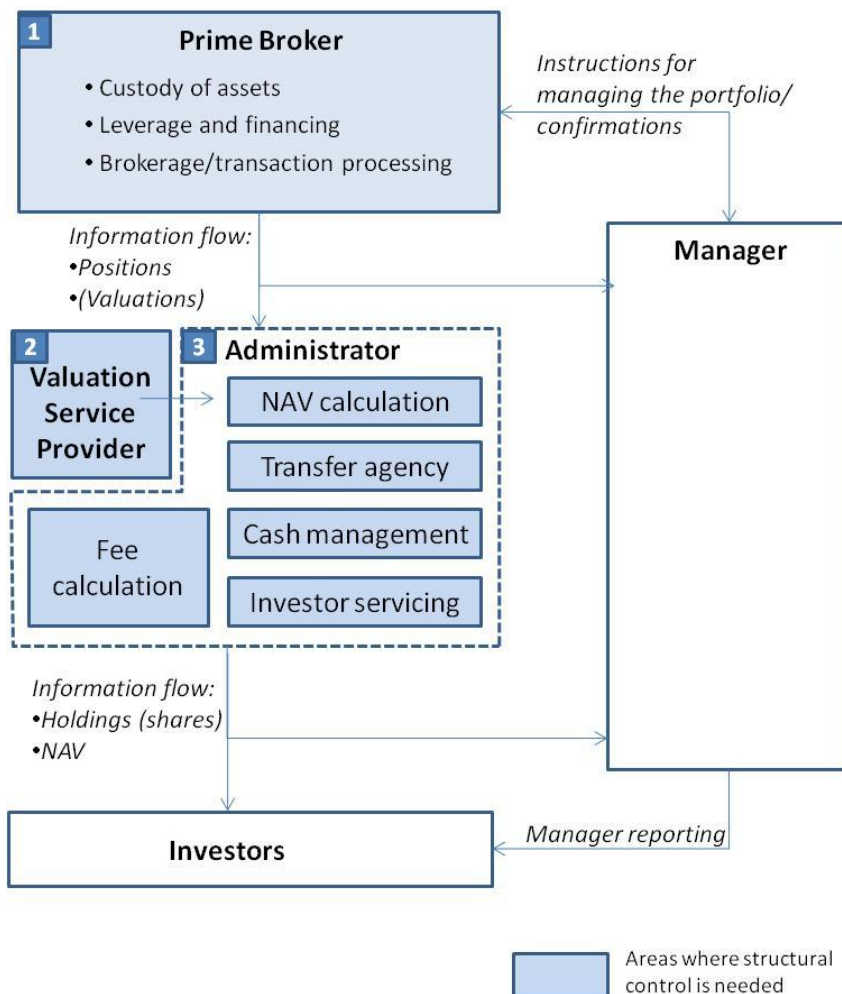
2.1 What is the issue?

When control and oversight over such administrative activities is entirely in-house under the control of the manager, concerns could arise about the risk of fraud by the manager, such as misrepresentation of assets (overstating the value of the portfolio) or even misappropriation of assets (cash, securities). Usually, the smaller an organisation and the fewer people involved in such activities, the larger the risk of such fraud.

2.2 What are we seeking to achieve?

- Ensuring that the existence of the actual assets of the fund is determined/confirmed by a third party (ie guard against misrepresentation of assets).
- Mitigating the risk of misappropriation of assets (cash, securities).
- Addressing and mitigating conflicts of interest in relation to asset valuation [This is already addressed by the existing Standard [5], “Segregation of functions in valuation”]

The following table illustrates the areas, where control/oversight should ideally be independent from the manager:



2.3 How are we seeking to achieve this?

There are many ways in which misrepresentation and misappropriation of assets can be prevented. A common approach is to have an independent party in charge of safekeeping and an independent administrator (along with an independent Prime Broker). This provides checks and balances and structural control.

3. What does the Hedge Fund Standards Board (HFSB) suggest to enhance the Standards?

In order to address the concerns mentioned above, the HFSB suggests the addition of the following Standard as part of Standard 17a [Operational risk – Governance Standards and Guidance]:

- **[Standard]: A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to appoint a third party, independent of the manager, responsible for the safekeeping and custody of the property of the fund.**

- **[Standard]: A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to appoint a third party, independent of the manager, in charge of administration to ensure the segregation of functions and the avoidance of conflicts of interest in relation to the calculation of the NAV and the maintenance of the accounting records of the fund.**
 - [Guidance:] HFSB 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.
 - [Guidance:] In such instances the manager should ensure that the internal process in charge of the NAV calculation and the maintenance of the accounting records is kept segregated from the portfolio management and trading functions. Such processes should be properly resourced and carried out by people who have sufficient expertise to handle the volume and complexity of instruments traded. The function should report to senior management of the firm independent of portfolio management and trading and have direct access to a fund's governing body.
 - [Guidance:] The process in charge of the NAV calculation and the maintenance of the accounting records of the funds should be audited annually by an independent auditor.

- **[Standard]: A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to disclose the nature, structure and governance of these arrangements.**

Consultation questions:

1. Do you agree with the analysis of these issues and the desired outcomes that we are seeking to achieve?
2. Do the proposed amendments to the Standards achieve the desired outcomes?
3. Do you agree that this should come under Operational Risk, Standard 17a?