hfSB
hedge fund standards board

Bringing managers and investors together to set standards for the hedge fund industry

Newsletter – May 2017

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New Stakeholders

The HFSB is delighted to welcome new additions to its family from the APAC region:

Investor Chapter

- Japan Post Bank (Japan)

Signatories

- Misaki Capital (Japan)
- Simplex Asset Management (Japan)

Open Protocol added to the HFSB Toolbox

The HFSB has become Co-Chair of the Open Protocol Working Group. The Open Protocol template standardises the collection and representation of risk information of hedge funds and other types of investment funds. Funds with over $1 trillion in assets under management currently use the template.

Open Protocol, an open standard which all investors and managers are free to adopt, has been added to the HFSB Toolbox. Open Protocol will become the fourth item in the HFSB Toolbox, following the publication of the Cyber Security Memo, Administrator Transparency Reporting and the Standardised Board Agenda.

Dame Amelia Fawcett, Chairman of the HFSB, said: "Better risk disclosure by investment funds has been a priority for both investors and regulators in recent years. Investors are looking continuously for better ways to aggregate risk information about their investments in order to improve overall portfolio risk management. Regulators also have started collecting data to assess potential systemic risk concerns. Open Protocol allows investors to harness data with aggregate risk exposures, while managers can streamline their own reporting to investors."

Please click here to read the press release in full.

HFSB in the APAC region

Melbourne & Sydney

This month leading Australian investors and HFSB signatories explored current industry issues at the annual HFSB gatherings in Melbourne and Sydney. The investor panel discussion focussed on alignment of interest, innovation of fee structures and emerging fee/cost transparency requirements for Australian Superfunds. The manager panel covered the following topics:

- **Better investor disclosure:** enhancing Administrator Transparency Reports with cost/fund expense information (e.g., rolling average 12-month total expenses), Open Protocol Risk Reporting and inclusion of stress tests in bespoke manager risk reports
- **Big data and artificial intelligence (AI)** "hype versus reality": overview of different approaches: a) using new "alternative" datasets to "feed" existing machines/algorithms; b) using better data (surveys, etc.) to inform discretionary investment decisions; c) true AI/deep learning techniques
- **How to instil better culture** in investment organisations (recruitment, incentive systems, collaboration)
- **Mitigation of conflicts of interest** in insurance-linked security funds, including in areas such as valuation and where managers are linked with re-insurance groups
- **Case study**: how a Chinese manager uses the Standards to address investor concerns

At the roundtable in Sydney, Gerard Fitzpatrick, Senior Executive Leader, Investment Managers and Superannuation at the Australian Securities Commission (ASIC) provided the opening remarks, highlighting current global and domestic regulatory priorities, including cyber security, the FSB and IOSCO's work on vulnerabilities in asset management, and ASIC's Regulatory Guide 259 on Risk management systems of responsible entities published in March 2017: "**I commend the HFSB for identifying the importance of adequate risk disclosure and its ongoing transparency initiatives, including the launch of the standardised Administrator Transparency Report last year and the Open Protocol risk reporting standard later this month. These initiatives are not just relevant to hedge fund managers, but to all alternative investment funds and beyond."**

The HFSB would like to thank the speakers from Albourne Partners, Alyeska Investment Group, Bloomberg, Future Fund, Ionic Capital Management, Hiscox Re Insurance Linked Strategies, MKP Capital Management, Springs Capital, PAAMCO and Telstra Super.

We particularly would like to thank our hosts, Future Fund and Bloomberg Australia, for hosting our events, as well as CAIA's Asia team for supporting our endeavours.

Seoul

This month the HFSB moderated a panel at the Alternatives Summit Korea (ASK) 2017 Global Summit, which included HFSB stakeholders from CQS, GCM Grosvenor and Springs Capital. The panellists discussed the current market environment, resulting opportunities, investor priorities and the importance of good standards.

Upcoming events

- **1 June, New York: Annual North American Stakeholder Forum**

  Speakers at the event include senior executives from CAM Capital, Canada Pension Plan Investment Board, Citadel, Man Group, Napier Park Global Capital, New Holland Capital and Teacher Retirement System of Texas. The closing remarks will be made by prominent speakers from the US Attorney's Office, Eastern District of New York.

- **5 June, Boston: HFSB Institutional Investor Roundtable**

  At this event, we will continue exploring the topics of alignment of interest, improving fee/expense disclosure, use of alternative data in investment management and how managers can instil a strong culture in their firms. Speakers include senior executives from Pension Reserves Investment Management Board, Frontlight Capital, KPMG, Ionic Capital Management, Man Numeric and MKP Capital Management.

- **7 September, London: HFSB Annual General Assembly.** Details to be confirmed.

The full event schedule is available here.

PRI launches responsible investment DDQ

The HFSB, alongside other HFSB stakeholders, participated in a working group led by the PRI to develop a due diligence questionnaire for hedge fund managers focussing on responsible investment. As a standard-setting body for alternative investment managers, the HFSB believes that issues in relation to good governance and investor disclosure are at the heart of its activities. The DDQ is available here. The HFSB will continue to explore this topic with its stakeholders in its Institutional Investor Roundtables.

Analysis of conformity with the Standards: Risk Management

Last month we looked at the explanations provided in relation to the Disclosure section. This month we will look at the Risk Management section.

Risk management, while being the largest section by the number of Standards, triggered proportionally fewer explanations compared to smaller sections, such as Valuation or Disclosure. This perhaps reflects a more qualitative and principle (concept)-based character of the areas covered by the Risk Management section. It should be noted that 83% of the explanations provided on risk management were done on a comply-***and***-explain basis, while the standard HFSB approach is comply-**or**-explain.

The Risk Management section focuses on risk framework, portfolio risk, liquidity risk management, control processes, operational risk and outsourcing risk.

The Standards recommend that a manager should put in place a risk framework, which sets out its approach to risk management and the governance structure for its risk management activities. Some signatories explain that they do not have a single risk framework but use various approaches to different types of risk.

Within the same group of Standards on risk framework, it is recommended that a hedge 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. The signatories here use a variety of approaches to disclosing their risk framework. While some of the signatories follow the recommendations of the Standards and disclose it via the fund's offering documents, others choose to disclose via their DDQs, general risk management presentations, transparency reports, risk reports, risk management summaries included in confidential memos etc. There was also a very small group of signatories who chose not to disclose their risk framework in the fund's offering documents due to confidentiality and proprietary reasons.

Another interesting area is the recommendation by the Standards to create a written Risk Policy Document, which sets out the responsibilities and procedures to be employed by the hedge fund manager's risk monitoring function. Here again, it is clear from the signatories' explanations that there is no single approach to dealing with risk policy documents. The list below includes some of the approaches used by the signatories:

- A comprehensive risk framework in place
- No single comprehensive risk policy document but provision of risk reports by the risk management committee
- Risk-related information is distributed via an operational framework to portfolio managers and operational staff
- No central risk policy document, but the firm's risk management framework and logic are hard-coded in their systematised investment process
- No formal written policy document, but "Informal" procedures are followed, including a financial risk management subcommittee
- Risk management procedures are provided in appropriate offering memoranda, prospectuses, supplements and disclosure documents.

A particularly important area worth noting is liquidity risk management, where the Standards recommend that a hedge 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. Here the signatories' approaches are:

- Liquidity risk is monitored on a position-by-position basis
- No liquidity risk framework exists because the signatory generally invests in (highly) liquid products
- The signatory established liquidity pools to cover a substantial portion of the fund's net asset value in order to provide liquidity in the event of a severe market dislocation.

A fair number of signatories explained in great detail how they manage their liquidity.

The same Standard also recommends that a hedge fund manager regularly should conduct stress-testing and scenario analysis of the fund's liquidity position. Most of the signatories conduct regular stress- testing; however, examples for explanations provided in this area are:

- Weekly analysis of liquidity but no systematic operational liquidity stress tests with respect to collateral management or cancellation of credit lines
- Daily margin reports, weekly fund flows reports, portfolio & stress testing reports for the Risk Committee meeting

- Reasons for not conducting regular liquidity stress tests include (a) fund does not trade illiquid or hard-to-value assets and all assets held are Level I and anticipated to be liquidated in one day; (b) limited use of leverage and use of multiple credit sources; (c) funds' liquidity pools provide adequate liquidity to meet the fund's obligations even in the event of a severe market dislocation.
- The signatory monitors any allocation to less liquid investment products and limits the size of this portfolio.

These explanations demonstrate the diversity of practices in the industry and reflect the wide variety of strategies managers pursue. This analysis also highlights once again the suitability of the "comply or explain" mechanism, which accommodates different types of managers regardless of their size, strategy or jurisdiction.

Next month we will explore the explanations provided in the Fund Governance section.

APPENDIX

Japan Post Bank JAPAN POST BANK Co., Ltd. is engaged in banking operations as a member of the JAPAN POST GROUP. In addition to implementing regional approaches in tune with customers in every corner of Japan through the post-office network that covers the whole country, the Bank strives to ensure stable revenues through global investments by advancing an increased level of investment sophistication on the basis of appropriate risk management. Through these efforts, the Bank is aspiring to become the largest institutional investor in Japan

Misaki Capital Misaki Capital Inc. based in Japan was founded in 2013 and manages a concentrated value-based Japanese listed equity fund that seeks to maximize absolute returns via constructive engagement with its portfolio companies. By utilizing both a financial and operational approach to shareholder engagement, Misaki strives to enhance the value of its businesses through improvements in both capital allocation and operational/strategic management using its team's extensive expertise in finance and management consulting.

Simplex Asset Management Simplex Asset Management Co., Ltd. ("Simplex") is a leading and independent hedge fund and investment management firm in Japan, established in 1999, For over a decade, Simplex has provided a range of services to a substantial and diversified global client base that includes sovereign wealth funds, endowments, foundations, financial institutions, and corporate pensions. Today, Simplex's world class investment professionals manage US$4 billion across three business lines; Hedge Funds, ETFs, and Structured Products.