HEDGE FUND STANDARDS

The ABI's Response to The Hedge Fund Working Group's Consultation Paper

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Introduction

1. This paper is the response of the Association of British Insurers to the consultation paper published in October 2007 by the Hedge Fund Working Group under the chairmanship of Sir Andrew Large on Hedge Fund Standards. Our members, as institutional investors with some £1.3 trillion of total funds under management, have a strong interest in the integrity of the investment markets as well as a direct interest reflecting their involvement as investors in and providers of hedge fund offerings.

2. The growth of the hedge fund sector is such that it exerts a significant influence on the working of the investment markets and financial system generally. The nature of the hedge fund model is one that, in seeking to identify market opportunities, must deal with market risk but this must be one in a responsible fashion. It is increasingly important that the sector should operate in a way that gives confidence to those investing through them and more widely.

3. We consider that the hedge fund industry has been right to take the initiative to set up the Working Group and publish these proposals which, in addressing concerns at an early stage and promoting greater transparency and adherence to best practice benchmarks will reduce the risk of burdensome or inappropriate regulation being imposed at a later date. It is also good that the UK industry has placed itself at the forefront such that it can lead development of best practice which will be for the wider good but also in the interest of the UK industry.

4. We feel that the consultation paper has largely identified the right issues and its proposals are generally well-pitched. The industry will need to demonstrate a real commitment to adhere in practice to what is proposed. This will require a genuine commitment to embrace these principles and to embed them in the operating culture of fund management firms. In this way the risk of a more compliance-led and bureaucratic regulatory approach being imposed at a later date can be avoided.

5. There are a number of areas, though, to which the Report could have given more explicit consideration or greater emphasis to. These are to do with quality of disclosure as to investment objectives of funds, better reporting on the actual risks being run through leverage rather than generalised discussion of the risks that leverage poses, analysis as to attribution of the components of fund performance, processes of external verification of valuation and performance and on timeliness of disclosure. These are all of obvious importance to investors in hedge funds and

meeting the information needs of such investors will be crucial to ensuring they are able to discharge their envisaged role of judging adherence to standards.

6. Much of the thrust of the proposals is predicated on the notion that investors in hedge funds will, though holding funds and their managers to account, underpin good or improving governance. We are unsure as to how far this objective will be deliverable through these means but it will certainly require a willingness on the part of funds and their managers willingly to supply relevant information, including identification of areas of non-compliance with best practice and provision of appropriate explanations, rather than any notion of expecting investors to push for supply of information. It is also unclear as the real recourse for inadequate explanations other than through decisions by investors to avoid the funds in question. This means that it will be important for levels and quality of compliance at an industry level to be properly monitored, analysed and disclosed and we suggest that thought is given to enhancements here.

7. In some areas the consultation paper flags that there is a role for further debate in determining how the proposals are to be taken forward. We highlight two particular areas of interest to us, the proposal that voting rights should only be exercised where there is a commensurate underlying economic interests, and the recommendation that the FSA introduce a regime for generalised disclosure of economic interests. What constitutes an economic interest will be of relevance to both these two proposals and needs careful thought. ABI members believe that economic positions are of obvious significance to market participants and treating them as such for disclosure rules would represent appropriate treatment based on substance rather than form. Ability and intention to use economic interests to influence companies based on actual or potential exercise of shareholder rights is not therefore the only reason for advocating a more generalised disclosure regime, which, we consider, should prove of benefit to market users as a whole.

ANNEX

Questions for Consultation

Part 1

Q14 Are there further issues that should be addressed by the HFWG?

Attribution within valuation (not just the risk associated with valuation methodologies) and transparency as to its verification need to be covered explicitly.

Q24 Are there any comments/observations on the way in which we envisage conformity with the standards? What would be the best forum for disclosing conformity with the standards?

Website publication together with disclosure in reports to actual and potential investors are the appropriate media for disclosure of conformity with the standards.

Q26 Would improvements to visibility, as suggested above, be useful? What other areas of information related to the hedge fund industry would be of value, taking into account the constraints mentioned? Would stakeholders see merit in firms who conform to the standards confirming this on their websites?

Yes, these improvements to visibility would be helpful and we believe that the scope of information needs to cover both firms and sector. In practice, information about the sector is likely to have greater relevance in helping to form views as to the prevalence of compliance and the effectiveness of the proposed standards. We note the reference to an undertaking to collaborate with AIMA to develop a methodology for collating industry data. However, this needs to extend beyond the collection of basic information and to include a process of periodic survey of the hedge fund sector with analysis of the returns to identify the degree adherence to the standards with the grouped data being published.

Regular publication of survey data with the process being overseen by the industry's trade body would be the best way to establish benchmarks and encourage progress. This is an approach that has worked for the mainstream fund management industry where the IMA undertakes a regular shareholder engagement survey which helps demonstrate institutional investor adherence to the Institutional Shareholders' Committee's statement of principles on the Responsibilities of Institutional Shareholders and Agents.

Yes, website publication of confirmation of conformity to the standards by individual hedge funds and their managers would be helpful but this needs to include something in the nature of discursive disclosure and not just a claim of compliance.

Q29 A Board of Trustees has been proposed as the next approach to ensure continuity for the HFWG. Are you comfortable with this recommendation vs. other alternatives? If not, what other governance

structure would be suitable? What mandate should the trustees have? Should the funding be wholly provided by the hedge fund industry, or should the industry's users contribute?

Yes, this approach seems sensible but the trustees need to have qualities at the individual level and at an aggregate level a balance of numbers that will ensure independence.

The mandate needs to be to ensure standards are up to date, to monitor level of adherence and promote confidence of investors and other interested parties.

The hedge fund industry and its users will need to fund it in one way or another but the providers of hedge funds are best placed to be the direct providers of the necessary financial resources.

Q29 Do industry practitioners agree that there is a need for more hedge fund industry specific educational training, and if so, what relevant areas should the curriculum cover? Which of the relevant areas are not yet covered by existing training curricula and how should these gaps be filled? (e.g. complementing existing curricula, creating new stand alone training, etc)?

We have no specific comments to make.

Part 2

Q5 The standards proposed in this document are largely based on disclosure rather than more prescriptive description of behaviour and practices. Would smaller hedge fund managers find such a disclosure-based approach difficult to comply with? If the currently proposed practices do pose challenges for smaller funds, specifically which practices are toughest and how would the funds suggest addressing those issues in lieu of our recommendations? Do the best practice standards strike the right balance between disclosure on the on hand, and the need for flexibility and innovation on the other?

We expect that small funds should find it easier to work within a best practice framework rather than rules.

It will create challenges for them, though

Yes, we think that an appropriate balance between flexibility and innovation has been struck.

Q7 Would the disclosure standards as articulated be sufficient in breadth and clarity to enable potential or actual investors to make well-informed decisions? Are there areas where further disclosures are required?

The expected beta of the fund is of key interest and relevance to investors. More detail of the contribution of leverage to performance and identification of returns that are genuine alpha is needed.

Q10 Would the proposed disclosures give investors a sufficient understanding of relevant commercial terms, such as fees, expenses and termination rights?

The way in which these are reflected in performance fees is of particular relevance.

Q14 Are additional disclosure standards required for either creditors or other third parties to enable them to make well-informed decisions?

We have no specific comments to make.

Q18 Given the importance of independence from the portfolio management function, are the improved valuation polices and procedures sufficient to meet the needs of investors? Should there be a more substantial role for administrators or other third parties in the valuation process beyond that set out in the HFWG report?

The consultation paper is right to devote significant space to outlining the required elements of best practice in this important area where procedures need to be robust and independence safeguarded. However, we suggest greater coverage is needed in regard to best practice for obtaining external verification of the valuation process.

Q23 Do the proposals for valuation of illiquid assets provide investors with sufficient confidence that pricing would be done in a fair, dependable and consistent manner?

Hopefully the proposals will provide an appropriate degree of confidence but we emphasise the challenges posed in respect of illiquid assets where model or broker prices are used. There is a need for prudence and there are conflicts of interests in so far as carried interest is levied on gains in assets that have not been crystallised and where an open market price in a liquid market is not available.

Q25 Are there other aspects of the proposed risk framework which are not laid out in the practices which should be considered?

We have not identified any particular deficiency.

Q45 Please comment on the proposal in relation to each of the specific areas of risk for which best practice is proposed: a) Portfolio risk, b) Operational risk, c) Outsourcing risk. Will the above approaches provide investors and counterparties with sufficient understanding and comfort about the handling of risk?

These areas of risk appear to have been dealt with in a fairly comprehensive manner.

Q51 Have we adequately covered the main issues in relation to this increasingly important area?

Yes

Q56 Are the governance and disclosure standards a useful addition towards market integrity? Would other market participants equally value clarification or improved definition as to what constitutes a "concert party"?

This is clearly a vitally important area where the paper encapsulates useful best practice standards and guidance. However, in the light of the FSA's views as expressed in Market Watch 24 (October 2007) it must be doubted whether the disclosure to investors that the manager has a policy to prevent market abuse, but with no disclosure of the actual policy being required, will of itself provide much assurance.

The matter of concert parties is a complex area where there is perhaps a legitimate interest in knowing where relationships between hedge fund investors are forged in pursuit of value-adding strategies. We see this as going beyond what one might term responsible exercise by shareholders of governance oversight of investee companies where a degree of cohesiveness can be a natural and responsible approach. The Takeover Panel has rightly been concerned that in the context of their scope of activity the safeguards of the Code are not circumvented where control-seeking activity is taking place.

Q58 To what extent would consultees value this new requirement?

It is appropriate that funds should have a policy and disclose it. The Institutional Shareholders' Committee paper on The Responsibilities of Institutional Shareholders and Agents may provide a useful starting point.

Q60 Would other consultees be prepared to enter debate about improved disclosure (e.g. of contracts for difference)?

ABI members firmly believe in the need for progress to be made in this area and we would value the opportunity for further debate with interested parties from the hedge fund arena. The initial position taken in the paper has been a timely contribution in view of the FSA's consideration of this important topic in CP 07/20.

It is important to consider to what extent the taking of material economic positions is of itself significant and to be important information for the proper functioning of the markets. Our Members consider that economic exposure is of primary significance and is so irrespective of any present intention on the part of the holder to exercise shareholder rights for the purpose of influence or control of the investee company. There is a legitimate debate to have as to where the threshold should be pitched for pure economic positions but our starting position is that the existing 3% threshold for disclosure as provided for under the Companies Act and specified by FSA should be extended to include aggregate long positions.

It is equally our view that transparency in respect of short economic positions of material size is needed for the efficient operation of the markets. It is the clear view of our Investment Committee that freedom by market participants to short-sell shares based on investment judgment should not be inhibited and that such activity has the potential to contribute to efficient price formation. There is no corresponding right to opacity, however, and we consider that confidence in the markets requires appropriate transparency. The relative arguments for disclosure of economic long and short positions vary somewhat and at times, concerns about lack of disclosure of economic short positions has been greater than that for economic long positions. Our view, though, has been that the case for a symmetrical disclosure regime is a strong one and hence we would argue for disclosure of shorts at a 3% threshold.

We will be considering more detailed aspects to this debate as we prepare our response to the FSA on CP 07/20 but stand ready to engage further with the Hedge Fund Working Group on this subject.

Q62 Would other consultees value a wider debate aiming at voting being restricted to those holding economic interest?

We would value the opportunity for further debate on this subject. The Consultation Paper is right to seek to identify a principle that votes should be restricted to those holding a corresponding economic interest.

We take it that the best practice recommendation for hedge funds relates to the holding of a relevant economic interest in the equity of the company (i.e. not extending to non-equity holdings). Hedge funds that seek to adhere to this best practice should then expect to comply or, where there is some ambiguity as to the circumstances, to explain the approach taken. We consider that this would be a helpful step forward in engendering confidence and acting as a benchmark of appropriate practice that other market participants might undertake to follow. Transparency in respect of economic positions, as we have already commented on, would further improve confidence.

Against this backdrop it would then be appropriate to consider what incremental benefits would then be achievable through a regulatory approach, bearing in mind the inherent complexity and also the need to respect legal rights of registered shareholders. This would certainly require very careful thought as to the definition of economic interest for this purpose and also the means by which regulation could be enforced. However, it would seem to be necessary to make at least some progress in tackling the first of these preparatory to finalisation of best practice and we would be pleased to contribute to the debate on this.