

Hedge Fund Working Group Issues Final Report

The UK-based Hedge Fund Working Group (the "HFWG") published its final report on hedge fund standards (the "Report") on January 22, 2008.¹ The Report sets out 28 best practice standards for hedge fund managers (the "Standards"). The HFWG was set up in July 2007 and the Report follows the HFWG's initial consultation paper issued in October 2007 (the "Consultation Paper").

The Standards and Their Scope

The Standards are aimed at UK hedge fund managers and purport to apply to fund managers only in respect of hedge fund management activity. The Standards make clear that they do not apply to other activities including, for example, management of funds of hedge funds or segregated accounts. However, the HFWG acknowledges that certain of the Standards may be appropriate for hedge fund managers to utilize in carrying out their other activities. Managers may want to consider the manner in which to apply the Standards where they have been appointed by a hedge fund platform to manage a pool of assets or where they are providing sub-advisory services to an unrelated hedge fund manager.

The Standards generally reflect the proposals originally suggested in the Consultation Paper. However, there have been some significant refinements and improvements as a result of the consultation process. The Report clarifies that while the Standards have been motivated by concerns to ensure investor protection and awareness, it is acknowledged that ultimate responsibility for such matters, and the actions

of a fund generally, rests with a fund's governing body. As such, many of the Standards are expressed in terms that the hedge fund manager should do what it reasonably can to enable and encourage the fund's governing body to take certain actions, rather than requiring that managers ensure certain actions are taken (as was proposed in the Consultation Paper).

The Standards purport to apply to all hedge fund managers that sign up, irrespective of size, assets under management, or length of establishment. However, some Standards include elements that take account of specific challenges facing smaller managers. Managers may choose not to comply with particular Standards provided they disclose why they are unable to comply with a particular Standard (the "comply or explain" regime).

The Standards

The Standards address five areas identified by the HFWG in the Consultation Paper as particular areas of concern for the industry:

DISCLOSURE²—There should be transparency about fees payable by a fund and appropriate investor disclosure of a fund's investment policy, associated risks, and commercial terms (including "material" side letter terms), as well as appropriate disclosure of information to a fund's counterparties. In addition, references to a fund's performance should contain appropriate disclosure of any factors which may be material to the robustness of the performance calculation in situations where, in the view of the

¹ Report available at <http://www.pellin.co.uk/HFWG/HFWG-FINAL-REPORT.pdf>

² Standards 1 – 4

manager, a fund has material exposure to hard-to-value assets.

- VALUATION³—Valuation arrangements should address and mitigate conflicts of interest in relation to asset valuation. The Report states that the most satisfactory way to achieve this is for a hedge fund manager to do what it reasonably can to enable the fund governing body to appoint an independent and competent third party valuation service provider. However, the Report acknowledges that in some cases it will not be possible in practice to achieve both independence and the required level of competence by appointing a third party valuation service provider. In circumstances where a manager determines the value of any of a fund's assets (whether by performing valuations in-house or providing final prices to a valuation service provider), the manager should operate a valuation function which is segregated from the portfolio management function and should explain its approach to investors.

In addition, managers should do what they reasonably can to enable and encourage the governing body of a fund to prepare, adopt and maintain a valuation policy document, which covers all material aspects of the valuation process and valuation procedures and controls in respect of the fund including, *inter alia*, valuation procedures aimed at ensuring a consistent approach to determining fair value.

If a fund uses “side pockets” for hard-to-value assets, managers should ensure that the fund governing body has been consulted on, and consented to, the circumstances in which side pockets may be used. Managers should then do what they reasonably can to enable and encourage the fund governing body to adopt suitable procedures and practices in relation to the side pocket and the assets within any such side pockets. Managers and fund governing bodies will need to take care when considering side pockets if they intend to comply with the Standards since the Standard regarding side pockets is relatively prescriptive.

³ Standards 5 – 8

- RISK MANAGEMENT⁴—Managers should put in place a risk framework, which sets out the governance structure for its risk management activities and specifies the respective reporting lines, responsibilities, and control mechanisms intended to ensure that risks remain within the manager's risk tolerance (or risk appetite) as conveyed to and discussed with the fund governing body. The risk framework should cover all relevant categories of risk (including portfolio, liquidity, market, counterparty, credit, operational, and outsourcing risks). Managers should explain their risk framework and approach to managing risk and should do what they can to enable and encourage a fund's governing body to explain that risk framework in the fund's offering documents, which should also fully disclose all relevant risks.
- GOVERNANCE⁵—Suitable and robust governance arrangements should be in place that are capable of dealing with potential conflicts between managers and investors.

Prior to establishment of a fund, managers should seek to encourage and assist the fund governing body to identify and recruit members of the fund governing body with suitable experience and integrity to enable the fund governing body to be able to discharge effectively its role with the appropriate level of independence.

Throughout the life of a fund, managers should be cognizant of the need for the fund governing body and governance processes to be effective and appropriate, advise the fund governing body accordingly, and do what it reasonably can to encourage and assist the fund governing body to make any changes which, in the light of such advice, the fund governing body considers to be necessary or desirable.

In addition, managers should carefully consider the extent to which the adoption by the fund governing body of all or parts of established codes of corporate governance or other director guidance is appropriate and do what it rea-

⁴ Standards 9 – 20

⁵ Standards 21 – 22

sonably can to encourage and assist the fund governing body to act accordingly.

- **SHAREHOLDER CONDUCT, INCLUDING ACTIVISM**⁶—In relation to the conduct of a fund as an investor, managers should ensure that they have internal compliance arrangements designed to identify, detect, and prevent breaches of market abuse laws and regulations. Managers should have a proxy voting policy which allows investors to evaluate their approach. Managers should not generally borrow stock in order to vote.

Maintenance of the Standards and Guidance

The Standards are to be maintained by the Hedge Fund Standards Board (“HFSB”), which is currently being constituted. However, the role of the HFSB is limited to being keepers and custodians of the Standards, ensuring their transmission, and reviewing their relevance. Guidance on the Standards is to be sought from existing sources, such as AIMA.

Complying with the Standards

By signing up with the HFSB, managers will be expected to adopt the Standards on a “comply or explain” basis. The Report acknowledges that new start-ups and/or smaller management concerns may find compliance impractical or unfeasible with certain Standards, and contains specific guidance on these instances. However, generally firms are treated on an equal footing and, provided an explanation for non-compliance is reasonable in the view of person to whom it is made, an explanation for those instances of non-compliance will be accepted by the HFSB. A signatory will have to maintain a written record of explaining instances of non-compliance to the HFSB or such other person as the HFSB may nominate.

Managers who sign up to the Standards will need to consider carefully how to achieve compliance as well as the implications of increased compliance and legal obligations. Managers who do not sign up will need to consider the potential legal and regulatory risks to their businesses posed by the existence of these

Standards (which a litigator or regulator may point to as an example of expected good industry practice).

Status in the United States

While the Standards are primarily aimed at UK-based and FSA regulated hedge fund managers, the Report expresses the HFWG’s hope that the Standards would be accepted by managers on a wider basis. The ongoing fulfilment of this aim is one of the tasks of the HFSB. The Standards currently have no standing or authority in the United States, however, and are not expected to in the future.⁷

The HFSB is charged with engaging with similar hedge fund standards programs around the globe, most notably the President’s Working Group in the United States, whose final report is expected in the coming months. When released, it is possible that the Standards may be modified to more closely fit with the President’s Working Group’s report.



For More Information

Anyone wishing to know more about the Standards and the potential impact of the Standards on their business should contact Peter Astleford (+44 (0) 20 7184 7860; peter.astleford@dechert.com), Stuart Martin (+44 (0) 20 7184 7542; stuart.martin@dechert.com), Jennifer Epstein (+44 (0) 20 7184 7403; jennifer.epstein@dechert.com), Keith T. Robinson (+1 852 3518 4705; keith.robinson@dechert.com), or their usual Dechert contact.

⁷ It should be noted that even in the UK, the Standards only represent industry best practice guidance. Compliance with the Standards in the UK provides no protection from actions by the Financial Services Authority.

⁶ Standards 23 – 28

Practice group contacts

For more information, please contact the authors, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financialservices.

Margaret A. Bancroft

New York
+1 212 698 3590
margaret.bancroft@dechert.com

Allison R. Beakley

Boston
+1 617 728 7124
allison.beakley@dechert.com

Sander M. Bieber

Washington, D.C.
+1 202 261 3308
sander.bieber@dechert.com

Stephen H. Bier

New York
+1 212 698 3889
stephen.bier@dechert.com

Susan M. Camillo

Boston
+1 617 728 7125
susan.camillo@dechert.com

Daphne T. Chisolm

Charlotte
+1 704 339 3153
daphne.chisolm@dechert.com

Christopher D. Christian

Boston
+1 617 728 7173
christopher.christian@dechert.com

Elliott R. Curzon

Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Douglas P. Dick

Washington, D.C.
+1 202 261 3305
douglas.dick@dechert.com

Ruth S. Epstein

Washington, D.C.
+1 202 261 3322
ruth.epstein@dechert.com

Susan C. Ervin

Washington, D.C.
+1 202 261 3325
susan.ervin@dechert.com

Joseph R. Fleming

Boston
+1 617 728 7161
joseph.fleming@dechert.com

Brendan C. Fox

Washington, D.C.
+1 202 261 3381
brendan.fox@dechert.com

Wendy Robbins Fox

Washington, D.C.
+1 202 261 3390
wendy.fox@dechert.com

David M. Geffen

Boston
+1 617 728 7112
david.geffen@dechert.com

David J. Harris

Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Robert W. Helm

Washington, D.C.
+1 202 261 3356
robert.helm@dechert.com

Jane A. Kanter

Washington, D.C.
+1 202 261 3302
jane.kanter@dechert.com

Stuart J. Kaswell

Washington, D.C.
+1 202 261 3314
stuart.kaswell@dechert.com

Geoffrey R.T. Kenyon

Boston
+1 617 728 7126
geoffrey.kenyon@dechert.com

George J. Mazin

New York
+1 212 698 3570
george.mazin@dechert.com

Jack W. Murphy

Washington, D.C.
+1 202 261 3303
jack.murphy@dechert.com

John V. O'Hanlon

Boston
+1 617 728 7111
john.ohanlon@dechert.com

Fran Pollack-Matz

Washington, D.C.
+1 202 261 3442
fran.pollack-matz@dechert.com

Jeffrey S. Poretz

Washington, D.C.
+1 202 261 3358
jeffrey.poretz@dechert.com

Jon S. Rand

New York
+1 212 698 3634
jon.rand@dechert.com

Robert A. Robertson

Newport Beach
+1 949 442 6037
robert.robertson@dechert.com

Keith T. Robinson

Hong Kong
+1 852 3518 4705
keith.robinson@dechert.com

Alan Rosenblat

Washington, D.C.
+1 202 261 3332
alan.rosenblat@dechert.com

Frederick H. Sherley

Charlotte
+1 704 339 3100
frederick.sherley@dechert.com

Patrick W. D. Turley

Washington, D.C.
+1 202 261 3364
patrick.turley@dechert.com

Brian S. Vargo

Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

David A. Vaughan

Washington, D.C.
+1 202 261 3355
david.vaughan@dechert.com

Anthony H. Zacharski

Hartford
+1 860 524 3937
anthony.zacharski@dechert.com

Kathleen Ziga

Philadelphia
+1 215 994 2674
kathleen.ziga@dechert.com



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