



Feedback Statement on Consultation Paper (CP2/2009): Administration and Safekeeping

1. Overview

The HFSB has invited comments on Consultation Paper 2/2009 (CP2/2009)¹. This paper summarises the feedback received, and presents the amendments to the Hedge Fund Standards². The last section details the process for implementing these amendments.

CP2/2009 relates to the mitigation of the risk of fraud and misrepresentation that can arise if safekeeping and administration of Hedge Fund assets is handled in house. The proposed 'Standards and Guidance' seeks to establish the practice of appointing a third party for the safekeeping and administration of Hedge Fund assets complemented by adequate disclosure to investors.

The HFSB would like to thank those who took the trouble to respond to the Consultation Paper and offered their feedback to us. We would also like to give special thanks to Tim West at Herbert Smith and Iain Cullen at Simmons & Simmons for their advice on the final drafting.

¹ The original consultation document is available at <http://www.hfsb.org/?page=11296>

² The Hedge Fund Standards can be found at <http://www.hfsb.org/?section=10564>

2. Feedback Received

(1) Do you agree with the analysis of these issues and the desired outcome that we seek to achieve?

Most respondents agreed with the analysis. Additional points raised in the responses include:

Additional Points Raised by Respondents:	HFSB Perspective:
Although the Standards recommend independent administration, they still allow for self-administration, leaving room for conflicts of interest. Self-administered funds would be hard to sell.	The “comply or explain” nature always allows for flexibility, provided that adequate disclosure is made to investors; i.e. instead of complying with a given Standard, a manager may choose to explain why it is not adhering to it. It is ultimately up to investors to decide, based on the disclosures, whether to invest or not.
It has been highlighted that a manager might not knowingly misstate the value of the portfolio for illiquid securities. This is why the HFSB should consider compiling a list of approved valuation service providers broken down into asset class and instrument type. It is acknowledged that this would be a major undertaking.	The HFSB is aware of the difficulties that arise in valuing illiquid securities. This is why the HFSB has set out Standards to cover Valuation of hard-to-value assets (Stds. 7+8). However, the HFSB acts solely as custodian of the Hedge Fund Standards. It does not assume the role of either a rating or approval agency for Hedge Fund Managers, nor does it evaluate service providers. However, service providers are encouraged to develop their own standards and guidance to help drive best practice in their respective areas.
“Cash management” does not fall within the usual meaning and understanding of the term fund administration.	It is correct that “cash management” is not a function that an administrator performs. No reference to cash management is made in the actual Standard.

2) Do the standards achieve the desired outcome?

Respondents broadly agree that the Standards achieve the desired outcome. However, some have recommended that the respective requirements should be enshrined in the regulatory framework, whereas others have highlighted the importance of independence in the valuation process (which is addressed separately in the existing Valuation Standards).

Additional Points Raised by Respondents:	HFSB Perspective:
The existing and the proposed new Standards address issues in relation to misappropriation of funds and misrepresentation of NAV. Should the issues of independent risk reporting be addressed?	Independence of risk monitoring is addressed in Standard 11, however, there is no explicit requirement to have structurally independent risk reporting to be provided to investors (i.e. with third party entities involved).

Additional Points Raised by Respondents:	HFSB Perspective:
Guidance should be added to clarify that the Standard does not require the appointment of a safekeeping entity by a feeder fund which holds only cash and shares or interests in a master fund.	The HFSB agrees, and the respective guidance has been added.
The Standard on independent administration should be enhanced with a requirement to employ an independent valuation service provider.	Issues in relation to valuation and independence of valuation services are addressed in the respective Valuation Standards (Stds. 5-8).
The use of a depositary should be a regulatory requirement.	This is indeed the case in some jurisdictions, and the draft Directive for Alternative Investment Fund Managers (AIFM) proposed by the European Commission requires independent custody and safekeeping. Nonetheless, given the global nature of the hedge fund industry, it is important to incorporate this aspect in the Hedge Fund Standards.
The requirement for independence and proper performance of the NAV calculation function should be enshrined in the regulatory framework.	The HFSB acknowledges that the proposed AIFM draft Directive might address this point. Nonetheless, given the global nature of the hedge fund industry, it is important to incorporate this aspect in the Hedge Fund Standards.
The disclosure of the arrangements to investors should be enshrined in the regulatory framework.	The HFSB acknowledges that the proposed AIFM draft Directive requires such disclosure to investors. Nonetheless, given the global nature of the hedge fund industry, it is important to incorporate this aspect in the Hedge Fund Standards.

3) Do you Agree that this should Come under Operational Risk, Standard 17a?

There has been no objection to inclusion under Standard 17a.

3. Proposed Amendments [New Standard/Guidance]

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 one or more third parties, independent of the manager, to be responsible for the safekeeping of the property of the fund.**
 - [Guidance:] The HFSB acknowledges that in the case of master feeder structures, it will not be appropriate for the feeder fund, which will normally hold shares/interests in the master fund and some cash, to appoint a third party responsible for safekeeping its assets. In such circumstances, however, the hedge fund manager should do what it reasonably can to enable the fund governing body to conduct appropriate due diligence on the master fund and the arrangements in place for the safekeeping of its assets.
 - [Guidance:] The HFSB acknowledges that prime brokers may take charges and/or security interests over the assets of a fund or may hold fund assets as collateral.

- **[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, with responsibility for fund administration (including calculation of the NAV and the maintenance of the accounting records of the fund) in order to ensure the segregation of functions and the avoidance of conflicts of interest in relation to the provision of fund administration services.**
 - [Guidance:] The 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 function in charge of the calculation of the NAV and the maintenance of the accounting records are kept segregated from the portfolio management and trading divisions. Such function should be properly resourced and carried out by staff who have appropriate expertise. The function should report to senior management of the firm.
 - [Guidance:] The internal function in charge of the calculation of the NAV and the maintenance of the accounting records of the funds should be audited annually by an independent auditor.
[Guidance:] Issues in relation to the valuation process are covered separately and included in Standard 5 and 6.
[Guidance:] Issues in relation to due diligence of third party service providers are also covered separately and included in Standard 19.

- **[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.**
[Guidance:] Issues in relation to disclosure of third party service providers such as administrators are also covered included in Standard 20.

4. Process for Incorporating these Standards

The existing HFSB signatories will need to revisit and adapt their Disclosure Statements to accommodate the amendments, if relevant and appropriate. The HFSB will grant 5 months to the signatories to incorporate the changes. Thereby, these amendments will be effective as of 1 August 2010.