

# Revisions to the Hedge Fund Standards and Feedback on Consultation Paper (CP4/2015)



## 1. Overview

This paper summarises the feedback received in response to [Consultation Paper 4 \(CP4/2015\)](#)<sup>1</sup> and sets out the amendments to the [Hedge Fund Standards](#)<sup>2</sup>.

CP4/2015 focused on (i) conflicts of interest that can arise between parallel funds (including partner/employee funds) and better disclosure of partner and employee co-investment in those funds, (ii) investor disclosure of trade allocation policies and (iii) sound internal arrangements to mitigate conflicts of interest.

The initial consultation paper was prepared by an international working group of investors and hedge fund managers, put together by the HFSB. The HFSB has received responses on this consultation from managers, investors and regulators; some of these responses will be made public on the HFSB website. The HFSB also has collected feedback at dedicated consultation roundtables and has discussed the proposals with its stakeholders at its Institutional Investor Roundtables. The HFSB would like to thank the working group and all those who invested their time and effort in responding to CP4.

Some of the respondents suggested improvements which went beyond the scope of the specific areas covered by the consultation. While these suggestions and comments were very valuable, currently they cannot be accommodated without further consulting all of the stakeholders. However, the HFSB has noted all these suggested improvements and will take them into account as it considers the need for future consultations on the Standards.

The HFSB signatories will need to revisit their approach to conformity with the new Standards and amend their Disclosure Statements to incorporate the new amendments, if relevant and appropriate. To allow signatories time to carry out this exercise, **the new amendments to the Standards will become effective on 2 May 2016.**

## 2. Consultation Feedback

CP4 proposed amendments to the Standards in three distinct areas:

- 1.) Disclosure of similar funds, accounts or vehicles, including partner/employee funds
- 2.) Disclosure of trade allocation policy to investors
- 3.) Internal arrangements to mitigate conflicts of interest

The following sections assess the feedback received. The original amendments proposed in CP4 are highlighted in red and revisions proposed following the consultation are highlighted in yellow.

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<sup>1</sup> [http://www.hfsb.org/sites/10377/files/hfsb\\_consultation\\_paper\\_%28cp4%29-\\_conflicts\\_of\\_interest.pdf](http://www.hfsb.org/sites/10377/files/hfsb_consultation_paper_%28cp4%29-_conflicts_of_interest.pdf)

<sup>2</sup> <http://www.hfsb.org/?section=1251>

## 2.1. Disclosure of similar funds, accounts or vehicles, including partner/employee funds

In CP4, the HFSB proposed that the scope of the existing Standard (2.4) on disclosure of the existence of parallel funds (including aggregate assets under management) pursuing the same strategy be expanded to:

- Widen the scope by referring to “similar” investment strategies rather than just strategies that are the “same”
- Provide transparency around the co-investment of partners/employees in the strategy and
- Include disclosure of the existence of partner/employee only funds (and their aggregate size)

### Exhibit 1: Assessment of feedback

Consultation feedback	HFSB perspective
<b>Question 1:</b> <i>Do you agree with the approach to widening the scope of the same / similar strategies? If not, please explain.</i>	
All respondents agreed with the approach to widen the scope of the Standard.	
<b>Question 2:</b> <i>Do you agree with the disclosure of aggregate (net) assets managed by the manager or should disclosure include <u>net and gross</u> assets under management (AUM)?</i>	
Most agreed that disclosure of net AUM was sufficient, with no strong indication for disclosure of gross exposure in addition to net assets under management. Respondents highlighted that, while the gross exposure may be of interest from a risk assessment perspective, it does not add much to assessing conflicts of interest. Where managers choose to disclose gross exposure, one respondent suggested that the Commitment Method for calculating exposure (as defined by the Alternative Investment Fund Managers Directive (AIFM-D)) should be used to ensure consistency with regulatory definitions and to avoid multiple calculations of AUM being conducted by the managers.	<b>The Standard/Guidance is kept as is, focussing on disclosure of net AUM.</b>
<b>Question 3:</b> <i>Which of the proposed definitions of “similar” (see i, ii, iii above) best captures potential conflicts of interests? Are there any suggestions for improvement (e.g., providing examples as guidance)?</i>	
Definition (i) and (ii) were favoured by most respondents, with some respondents suggesting that additional context (e.g., examples) should be provided to clarify how to apply the definition.	<b>See separate assessment in section 2.1.1 (Definition of “Similar”) and 2.1.2 (HFSB Assessment) below</b>
<b>Question 4:</b> <i>Do you agree with the proposed approach to disclosure of employee/partner funds? If not, please explain.</i>	
The respondents agreed with the proposed approach to disclosure of employee/partner funds. One respondent suggested that the fees/terms and conditions of those manager-only investment vehicles should be disclosed.	At present, the Standards do not require the disclosure of the detailed terms of all parallel funds/accounts/vehicles (incl. employee funds). However, the Standards cover the disclosure of “material adverse effects” of parallel funds/accounts/vehicles (incl.

Consultation feedback	HFSB perspective
	<p>employee funds) [Std. 2.4] and side letters that contain material terms (e.g., more favourable redemption treatment) [Std. 2.3]. Thus, any terms which have “material adverse effects” should be disclosed. This enables investors to conduct further due diligence in this area.</p> <p><b>The proposed Standard is kept as is.</b></p>
<p><b>Question 5:</b> <i>It is common practice for managers to disclose aggregate firm AUM. Is there a need for a separate Standard requiring disclosure of all funds/accounts/vehicles (aggregated by strategy) to enable better investor due diligence of how firms allocate internal resources to different strategies?</i></p>	
<p>Most respondents agreed that it is common practice to disclose aggregate firm AUM and a breakdown by strategy and that this information often is included in the marketing materials and DDQs of managers, but no dedicated Standard is needed to address this. Some respondents highlighted that the AUM at strategy level is not truly reflective of how a firm allocates internal resources, while others suggested that the number of funds/accounts per strategy might be a more useful indicator.</p>	<p>Understanding the resource allocation of investment firms to different areas of activity is part of investor due diligence, and many factors play a role in assessing this.</p> <p><b>The proposed Standard is kept as is.</b></p>

## Exhibit 2: Proposed amendments to Standard 2.4 [Commercial Terms Disclosure]

*There have been no changes vis-à-vis the original consultation proposal.*

### Upon request, disclosure of [under Standard 2.4] :

- a) Existence of **any other** funds, ~~or~~ accounts **or vehicles** managed by it using the same **or similar**<sup>1</sup> investment strategy,<sup>2</sup>
- b) **any material adverse effects** which the existence of such other funds, ~~or~~ accounts **or vehicles** may have on investors in the fund,
- c) the aggregate value of assets managed by the manager using the same **or similar**<sup>1</sup> investment strategy,
- d) **the aggregate size of employee or partner interests in the investment strategy,**<sup>3</sup>
- e) **the existence of any other funds or accounts managed by it which follow the same or similar**<sup>1</sup> investment strategy to the fund and which are available for investment only by partners or employees (or their connected persons) of the hedge fund manager,<sup>2,4</sup> and
- f) **in the case of (e) above, the size of such funds or accounts.**<sup>3</sup>

Footnotes:

**1 [See separate definition of “similar” in the next section below]**

**2** For the avoidance of doubt, the Standard requires hedge fund managers to disclose that they manage other funds ~~or~~, accounts **or vehicles**, but does not require disclosure of specific details of such funds ~~or~~, accounts **or vehicles**.

**3** For the avoidance of doubt, the Standard requires disclosure of aggregate partner/employee investment in the respective strategy, not a person-by-person break-down.

4 For the avoidance of doubt, a feeder fund, accessible only to partners or employees (or their connected persons) which only invests into a master fund accessible to external investors through a different feeder does not fall under this disclosure.

### 2.1.1 Definition of “Similar”

One of the challenges of this consultation was to define what constitutes a “similar” strategy (see Exhibit 3 for an overview of possible definitions). On the one hand, it is not intended to capture funds/accounts/vehicles which have some identical underlying positions but which do not trade in parallel – it would be very difficult for managers to monitor this situation. On the other hand, it is important to capture, for example, a multi-strategy set-up where a fund is similar in relation to a sub-strategy of such a multi-strategy fund, in particular in situations where trades may have scarce capacity.

Most respondents agreed that conflicts of interest can arise in this context and need to be understood and addressed. However, the consultation feedback did not provide a clear indication as to the preferred definition, some respondents preferring definition (i), others preferring definition (ii). No respondent preferred definition (iii).

#### Exhibit 3: Overview of possible definitions of “similar strategies”

<b>(Footnote 1)</b> Similar strategies should be interpreted to include funds, accounts or vehicles managed by an investment management team or individual within the hedge fund manager and which trade <u>substantially</u> in parallel...		
... with the fund/account/vehicle or, in the case of a multi-strategy fund, with one or more sub-strategies of the fund.	... in whole or in part with the fund. Substantially similar trading patterns over time, rather than overlapping positions by themselves, is the key indicator (i.e., overlapping positions by themselves do not define similarity).	... in whole or for some sub-strategies with the target fund or are part of the same trade allocation approach.
<b>(i)</b>	<b>(ii)</b>	<b>(iii)</b>
	<b>Definition adopted by HFSB (in combination with non-binding guidance example)</b>	

One respondent suggested that the term “substantially” should be better defined. Others highlighted that the definitions require examples or additional context to make them effective. In that regard, one respondent provided an example of non-binding guidance to help determine similarity (see Exhibit 4).

#### Exhibit 4: Proposed non-binding guidance to determine similarity

- 1.) The Portfolio Manager or investment team, the investment mandate (i.e., equity, fixed income, macro) and the strategy or style (i.e., market neutral, relative value, trend following) will all need to be the same.
- 2.) Additionally, the “similar” fund or separately managed account will have to have an 80% overlap in the following 4 areas (an example follows each item):

- a) **Asset classes traded** (i.e., mortgages, equity, credit, FX) - If the fund is 100% equities, then other funds/sleeves must have at least 80% in equities to be classified as similar.
  - b) **Target risk and return** - Funds must have similar risk-return targets (measured by Sharpe or Information Ratio) to be classified as similar. Thus, if the fund targets a Sharpe ratio of 1, then “similar” funds must target a Sharpe between 0.8 and 1.2 (+/-20% band).
  - c) **Time horizon of positions** - If the average holding period for the fund is 3 months, then the holding period for the similar fund needs to be between 2.4 to 3.6 months (+/- 20% band).
  - d) **Average liquidity of positions** - If the average liquidity profile of the fund is 10 days, then the similar fund needs to have an average liquidity profile between 8 to 12 days to be classified as similar (+/- 20% band).
- 3.) A multi-strategy fund would have to have 80% overlap of allocations among sub-strategies, and the sub-strategies would have to be substantially similar (80%), as in item 2 above.

The respondent suggested that the above framework should be used to determine and review annually which funds or separately managed accounts have similar investment strategies; this information then could be provided to clients upon request. The framework also should provide guidance on “how” to determine which funds or managed accounts should be grouped as falling within “similar” investment strategies. The respondent proposed that the framework only should be set out as guidance and not included within the Standard, as individual circumstances may mean that some of the criteria cannot be applied, which could result in an inaccurate outcome for a particular signatory.

2.1.2 HFSB Assessment

The HFSB agrees that providing additional guidance by means of examples will help firms develop a meaningful approach to assessing similarity of funds/managed accounts.

The HFSB acknowledges that the proposed definitions (i) and (ii) ultimately may deliver similar outcomes. While definition (i) explicitly singles out the “multi-strategy” fund scenario, definition (ii) is more generic (but also captures multi-strategy funds) and also specifies that similar trading patterns rather than just overlapping positions determine similarity. **Therefore, definition (ii), in combination with the (non-binding) examples provided in Exhibit 4, will help investors and managers assess funds that trade substantially in parallel, while providing room for judgement in individual circumstances.**

2.2 Disclosure of Trade Allocation Policy

In line with regulations in many jurisdictions, the HFSB has suggested that a manager should put in place a trade allocation policy. The new Standard also requires the disclosure of the trade allocation policy to investors (upon request).

Exhibit 5: Assessment of feedback

Consultation feedback	HFSB perspective
<b>Question 6:</b> Do you agree with the proposed standard, including disclosure of the trade allocation policy to investors (upon request)? If not, please explain.	

Consultation feedback	HFSB perspective
<p>All respondents agreed with the general approach to better disclosure. Some respondents highlighted that trade allocation policies can be very complex and may contain proprietary intellectual capital.</p> <p>One respondent explained that often an incremental, more tailored approach to disclosure is required to respond to specific inquiries by investors and that the full policy is made available to clients, upon request, on-site. Another respondent highlighted the need for more clarity around the contents of the trade allocation policy.</p>	<p>The HFSB agrees that trade allocation policies can be complex and very technical (in particular for large or more complex firms) and acknowledges the importance of protecting proprietary intellectual capital, while enabling investors to conduct adequate due diligence of a manager’s approach. While restricting the approach to “on-site” disclosure may not always be practicable, <b>the new Standard accommodates the confidentiality concerns by requesting “disclosure of the trade allocation policy upon request on a confidential basis”</b>, leaving it to the manager to determine the required level of confidentiality of the information (i.e., via virtual data rooms, which allow “view only” access, watermarking and activity monitoring to ensure confidentiality)<sup>3</sup>. Separately, the HFSB will explore with its stakeholders whether any additional guidance (e.g., via the HFSB Toolbox) is needed as to the contents/structure of trade allocation policies.</p>

#### Exhibit 6: New Standards 17i.1 and 17i.2 [Operational risk

**17i.1 A manager should put in place a trade allocation policy.**  
**17i.2 Upon request, a manager should disclose the trade allocation policy to investors on a confidential basis.**

### 2.3. Internal Arrangement to Mitigate Conflicts of Interest

The HFSB has suggested that managers should put in place internal arrangements to mitigate conflicts of interest. As indicated in CP4, regulations in many jurisdictions cover conflicts of interest with varying levels of detail. For example, the European UCITS and AIFM Directives have detailed requirements to identify, manage, monitor and, where applicable, disclose conflicts of interest. In the US, Form ADV highlights a manager’s fiduciary duties and requires full disclosure of all material conflicts of interests that could affect the advisory relationship. Managers who comply with such regulations most likely will comply with the proposed Standard.

#### Exhibit 7: Assessment of feedback

Consultation feedback	HFSB perspective
<p><b>Question 6:</b> <i>Do you agree with the proposed standard, including disclosure of the trade allocation policy to investors (upon request)? If not, please explain.</i></p>	
<p>There should be more focus on allocation of expenses and identifying hidden fees charged to the fund (e.g., guidelines or principles for defining which types of expenses are eligible to charge to the fund).</p>	<p>Allocation of expenses is currently included in the list of areas where conflicts of interest can arise. However, this consultation does not explore the possibility of establishing an expense allocation framework, which will require a separate project to assess this topic in more detail. At present, the Standards address issues in relation to fees/expenses in the Commercial Terms disclosure section (i.e., Std. 2.1), focussing on the disclosure to investors. In</p>

<sup>3</sup>See comparison at <http://virtual-data-rooms.softwareinsider.com/>

Consultation feedback	HFSB perspective
	<p>addition, the HFSB has explored this topic at past Institutional Investor Roundtables, and while certain commonly accepted expense allocation practices are emerging in the industry, it is important to highlight that some choices of expense allocation constitute commercial considerations/negotiations between managers and their investors, with no singular “right” Standard. Going forward, the HFSB will continue to explore this topic with its stakeholders to determine what additional work may be needed.</p>
<p>There should be a disclosure section on Soft Dollars, both how many are generated and how they are spent.</p>	<p>The fair use of dealing commissions is currently an area of regulatory focus. The HFSB is awaiting the conclusions of the regulatory process to determine with its stakeholders if further action is needed in this area. Since it is certainly an area where conflicts of interest can arise, <b>“Dealing Commissions/Soft Dollars” has been added to the list of examples.</b></p>
<p>Within the conflicts examples, the following key additional conflicts also should be included in the list: use of soft dollars, other business interests of investment manager employees, gifts and entertainment, suspension and/or gating of redemption. One respondent suggested that conflicts of interest policies should be made available to investors upon request.</p>	<p><b>The examples (other business interests of investment manager employees, gifts and entertainment, suspension and/or gating of redemptions) have been added to the list.</b></p> <p>The disclosure of a “conflict of interest policy” has not been explicitly consulted on and would require further exploration by the HFSB and a separate consultation. Depending on jurisdiction, firms have to meet varying regulatory requirements in terms of organisational and administrative arrangements to prevent/manage conflicts of interest and to record them. An overview of the various regulatory requirements is included in the <a href="#">Appendix C of the consultation paper CP4</a>. At present, there is no regulatory requirement for the disclosure of a “conflict of interest policy”.</p>
<p>Not all conflicts can be adequately managed or their outcome mitigated to such a point as to make it appropriate to accept them. Therefore, some conflicts must be avoided, and the Standards should make this clear.</p>	<p>This would require the development of a list of criteria to determine all “unacceptable conflicts” which in turn would require a separate consultation process. One question in this context is whether it is realistic and practical to come up with such a list of specific “unacceptable conflicts” or whether it is more effective to focus on conduct principles/standards, as well as disclosure. The HFSB will continue to review this topic going forward.</p>
<p>“Periodic” should be defined as either monthly or no less frequent than quarterly to ensure the reporting is timely to senior management, as well as the board of Fund directors, where applicable. It also could be worthwhile to include a passage which notes “or, in the case of conflicts requiring the approval of</p>	<p><b>We have specified “periodic” by including (e.g., monthly or quarterly), and added “where applicable, reported to the fund governing body”). We also have added “or, in the case of conflicts requiring the approval of senior management, escalated as soon as reasonably practical”.</b></p>



Consultation feedback	HFSB perspective
senior management, escalated as soon as reasonably practicable” after “periodically”.	

#### Exhibit 8: New Standard 17k.1 [Operational risk]

**17k.1 A manager should ensure that it has internal arrangements to manage and mitigate conflicts of interest, and this should include documented compliance policies and procedures (e.g., conflicts of interest policy). Conflicts of interest should be recorded and reported to senior management on a periodic basis (e.g., monthly or quarterly) or, in the case of conflicts requiring the approval of senior management, escalated as soon as reasonably practical. Where applicable, conflicts of interest should be reported to the fund governing body.**

Examples of conflicts of interest may include, but are not limited to:

- a) Cross trades
- b) Fair allocation of trades / opportunities across different funds or accounts
- c) Employee/partners funds
- d) Funds that in turn invest in other internal/external funds with incremental fees
- e) Internal resource allocation across different funds/client accounts
- f) Personal Account dealing policies
- g) Allocation of expenses
- h) Use of affiliated service providers
- i) Lack of independent valuation
- j) Differential terms or fees
- k) Use of soft dollars/dealing commissions
- l) Other business interests of investment manager employees
- m) Gifts and entertainment
- n) Suspension and/or gating of redemptions

### 3. Process for Incorporating These Standards

HFSB signatories will need to revisit their approach to conformity with the new Standards and amend their Disclosure Statements to incorporate the new amendments, if relevant and appropriate. To allow signatories time to carry out this exercise, **the new amendments to the Standards will become effective on 2 May 2016.**



## Appendix: Summary of the New Standards

### Amendments to Standard 2.4 [Commercial Terms Disclosure]

Upon request, disclosure of [under Standard 2.4] :

- d) Existence of ~~any other~~ funds, ~~or~~ accounts **or vehicles** managed by it using the same **or similar<sup>1</sup>** investment strategy,<sup>2</sup>
- e) **any material adverse effects which the existence of such other funds, ~~or~~ accounts or vehicles may have on investors in the fund,**
- f) **the aggregate value of assets managed by the manager using the same **or similar<sup>1</sup>** investment strategy,**
- g) **the aggregate size of employee or partner interests in the investment strategy,<sup>3</sup>**
- h) **the existence of any other funds or accounts managed by it which follow the same or similar<sup>1</sup> investment strategy to the fund and which are available for investment only by partners or employees (or their connected persons) of the hedge fund manager,<sup>2,4</sup> and**
- i) **in the case of (e) above, the size of such funds or accounts.<sup>3</sup>**

Footnotes:

1 Similar strategies should be interpreted to include funds, accounts or vehicles managed by an investment management team or individual within the hedge fund manager and which trade substantially in parallel in whole or in part with the fund. Substantially similar trading patterns over time, rather than overlapping positions by themselves, is the key indicator (i.e., overlapping positions by themselves do not define similarity).

2 For the avoidance of doubt, the Standard requires hedge fund managers to disclose that they manage other funds ~~or~~, accounts **or vehicles**, but does not require disclosure of specific details of such funds ~~or~~, accounts **or vehicles**.

3 For the avoidance of doubt, the Standard requires disclosure of aggregate partner/employee investment in the respective strategy, not a person-by-person break-down.

4 For the avoidance of doubt, a feeder fund, accessible only to partners or employees (or their connected persons) which only invests into a master fund accessible to external investors through a different feeder does not fall under this disclosure.

### Example for an approach to assess similarity (not part of the Standards):

- 1.) The Portfolio Manager or investment team, the investment mandate (i.e., equity, fixed income, macro), and the strategy or style (i.e., market neutral, relative value, trend following) will all need to be the same.
- 2.) Additionally, the “similar” fund or separately managed account will have to have an 80% overlap in the following 4 areas (an example follows each item):
  - a) **Asset classes traded** (i.e., mortgages, equity, credit, FX) - If the fund is 100% equities then other funds/sleeves must have at least 80% in equities to be classified as similar.
  - b) **Target risk and return** - Funds must have similar risk-return targets (measured by Sharpe or Information Ratio) to be classified as similar. If the fund targets a Sharpe ratio of 1 then “similar” funds must target a Sharpe between 0.8 and 1.2 (+/-20% band).
  - c) **Time horizon of positions** - If the average holding period for the fund is 3 months then the holding period for the similar fund needs to be between 2.4 to 3.6 months (+/- 20% band).

d) **Average liquidity of positions** - If the average liquidity profile of the fund is 10 days then the similar fund needs to have an average liquidity profile between 8 to 12 days to be classified as similar (+/- 20% band).

3.) A multi-strategy fund would have to have 80% overlap of allocations among sub-strategies, and the sub-strategies would have to be substantially similar (80%) as in item 2 above.

*The framework can be used to determine and review annually which funds or separately managed accounts have similar investment strategies.*

#### **New Standards 17i.1 and 17i.2 [Operational risk]**

**17i.1 A manager should put in place a trade allocation policy.**

**17i.2 Upon request, a manager should disclose the trade allocation policy to investors on a confidential basis.**

#### **Proposed new Standard [Operational risk]**

**17k.1 A manager should ensure that it has internal arrangements to manage and mitigate conflicts of interest, and this should include documented compliance policies and procedures (e.g. conflicts of interest policy). Conflicts of interest should be recorded and reported to senior management on a periodic basis (e.g. monthly or quarterly) or, in the case of conflicts requiring the approval of senior management, escalated as soon as reasonably practical. Where applicable, conflict of interest should be reported to the fund governing body.**

Examples may include, but are not limited to:

- a) Cross trades
- b) Fair allocation of trades / opportunities across different funds or accounts
- c) Employee/partners funds
- d) Funds that in turn invest in other internal/external funds with incremental fees
- e) Internal resource allocation across different funds/client accounts
- f) Personal Account dealing policies
- g) Allocation of expenses
- h) Use of affiliated service providers
- i) Lack of independent valuation
- j) Differential terms or fees
- k) Use of soft dollars/dealing commissions
- l) Other business interests of investment manager employees
- m) Gifts and entertainment
- n) Suspension and/or gating of redemptions