

# Key Guidance On Hedge Fund Investing

*Advice and Best Practices for Investors and Fiduciaries*

**Web Seminar**

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# Hedge Fund Best Practices

Two committees formed by the President's Working Group on Financial Markets issued reports:

- Asset Managers' Committee ("AMC")
- Investors' Committee ("IC")

# Asset Managers' Report

Focuses on policies and procedures that hedge funds should adopt to “reduce systemic risk and foster investor protection”:

- Disclosure
- Valuation
- Risk management
- Operations and Compliance

# AMC Report: Disclosure

Modeled like public companies:

- Financial statements audited in compliance with generally accepted accounting principles
- Performance updates, annually and quarterly
- Prompt disclosure of important events
- Provide quantitative and qualitative information about financial condition
- Improve disclosure to banks, broker-dealers and other contract counterparties

# AMC Report: Risk Management

Evaluate risk profile in light of investment activities:

- Adopt policies to regularly monitor risk
- Fully disclose the risk of their strategies to investors

# AMC Report: Operations and Compliance

- Appoint a senior management employee to guarantee all back office operations are conducted accurately
- Adopt written compliance policies
- Appoint a chief compliance officer

# IC Report: Principals and Best Practices for Hedge Fund Investors

Consider fundamental observations when assessing risks:

- Evaluating can be difficult – broad range of complex, illiquid and sometimes opaque investments and investment strategies
- Be aware of the difference between risk and uncertainty
  - risk - element of randomness
  - uncertainty – arises from incomplete knowledge; not quantifiable
- Process requires additional resources and support
- Fiduciaries must be sophisticated in knowledge and experience
- Fiduciaries should not expect 3<sup>rd</sup> party consultants to assess all relevant aspects of their program or its strategic role in portfolio

# IC Report:

## Hedge Fund Investments and Allocations

### 1. Considerations Prior to Investing in Hedge Funds

*Only pursue a hedge fund investment if:*

- Hedge fund manager is skilled in active investing and the investment offers investment strategies to which exposure is most effectively gained through a hedge fund
- Benefit of this skill and non-traditional strategy exposure remains after fees, expenses and due diligence costs
- Fiduciary can differentiate between skill-based managers from those generating profits from generic market exposure
- Fiduciary will have opportunity to invest in hedge funds that they have identified as suitable

# IC Report: Hedge Fund Investments and Allocations

## 2. Roles in the Portfolio

- *Complements* traditional stock and bond investments
- *Integrates* with a traditional asset class as part of a value-added strategy
- *Substitutes* for an allocation to tradition investments

# IC Report:

## Hedge Fund Investments and Allocations

### 3. Allocation and Diversification

*Consider:*

- The expected return and risk profiles of the proposed hedge fund investments, including liquidity risk, business risk, and the potential outcomes of the investment strategy under various conditions
- How the hedge fund allocation benefits the overall portfolio in terms of projected returns and volatility

# IC Report:

## Hedge Fund Investments and Allocations

### 6. Allocation and Diversification

#### *Guidelines:*

- The greater the allocation to hedge funds, the more important it is to consider diversification across investments and managers.
- Fiduciaries of organizations that lack sufficient resources or the desire to conduct appropriate due diligence and monitoring should consider investing in funds of hedge funds.
- For investments in stand-alone allocation, diversification across investment strategies may be as important as diversification among managers.

# IC Report: Hedge Fund Investment Policy

- What is the strategic purpose of investing in hedge funds – the role they play in the total investment portfolio?
- Is the hedge fund program consistent with the applicable investment beliefs, objectives and risk profile of the investment program?
- What are the performance and risk objectives of the hedge fund investment program?
- Who will manage the hedge fund investment program and what responsibilities will they have?
- What investment guidelines will apply to the range of funds and strategies that can be utilized, the number of funds to be targeted, and the risk and return targets for those funds?

# IC Report: Due Diligence

The due diligence process is a set of procedures used to gather information about a particular investment for the purpose of deciding whether the investment opportunity is appropriate.

## 1. Generally

- Best practice objectives are applicable across all investment activities and categories
- Exercise particular care
  - Employ complex investment strategies
  - Frequently young and small
  - Use leverage and the associated risks
  - Possibilities of concentrated exposure to market and counterparty risks, and generally more lightly regulated nature of these organizations

# IC Report: Due Diligence

## 2. Personnel

- Reputation, experience and background of hedge fund managers and key principals in firm
  - Industry contacts, references, professional background searches, regulatory registrations, disciplinary history
  - Mitigates risk of investing with managers with poor reputations or lack of experience
- Consider risk associated with loss of a key person or persons
  - Assess whether a fund's redemption provisions adequately mitigate risk

# IC Report: Due Diligence

## 3. Business Management

- Governance and compensation structures, nature and breadth of ownership of the manager, degree of client concentration, and stability of client base
- Assess stability of the manager's overall business

## 4. Investment Performance Track Record

- Understand the manager's historical performance and the factors contributing to that performance
- Assess the manager's ability to operate a fund successfully in varying market environments

# IC Report: Due Diligence

## 5. Style Integrity

- Employ regular and frequent risk monitoring and actively analyze a hedge fund's risk exposures as a means of evaluating potential style drift
- Obtain appropriate risk reports, with sufficient frequency, to monitor potential style drift and to confirm that the hedge fund continues to meet the investor's objectives

# IC Report: Due Diligence

## 6. Model Use

- Depends on nature of the strategy, complexity of the mandate, and types of models used
- Assess hedge fund manager's reliance on models, including assumptions, model inputs, and risks associated with the models the manager employs
- Assess the expected frequency of material and substantive model changes, and whether the manager intends to notify investors when such changes are made

# IC Report: Due Diligence

## 7. Ongoing Monitoring

- Continuation of due diligence process
- Continually reaffirms assumptions used in the initial selection remain valid
- Key aspects of monitoring process include:
  - o Reviewing strategy and performance for consistency
  - o Maintaining awareness of factors indicating potential style drift
  - o Confirming that there has been no material change to the business operations of the fund manager
- Take reasonable steps to identify any events or circumstances that may result in the fund failing to meet standards and expectations that were originally required

# IC Report: Best Practices – Risk Management

## 1. Investors' Risk Management Programs

- Develop programs appropriate to their size, complexity, and portfolio structure, including appropriate quantitative and qualitative criteria for the reasonable measurement, monitoring, and oversight of risk
- Establish formal written policies and supervisory procedures
  - Reviewed and updated no less frequently than annually and within a reasonable time after any material change in investment objective, strategy, market conditions or applicable regulations
- Independent of the manager selection process and the process for monitoring investment performance
- Engage outside consultants if necessary

# IC Report: Best Practices – Risk Management

## 2. Hedge Fund Risk Management Programs

- Understand hedge fund manager's risk management philosophy and processes, and be familiar with the relevant markets and trading strategies employed
- Determine that the manager has an independent risk management function whose compensation is not directly tied to portfolio performance and that reports to senior management of the fund
  - If absent, determine that the structure provides meaningful risk to the fund
  - Adequately resourced and staffed

# IC Report: Best Practices – Risk Management

2. Hedge Fund Risk Management Programs contd.
  - Review and understand policies and procedures – formal and informal – to determine if they effectively address market risks, including the risk of extreme events
  - Prior to making an investment decision, review samples of the reporting provided by managers and determine if the reports adequately address the disclosure needs and risk parameters of the investor

# IC Report:

## Best Practices – Risk Management

### 3. Investment Risks

- Be familiar with forms of Market and Market-related Risks:
  - o Equity risk
  - o Interest rate risk
  - o Currency risk
  - o Credit risk
  - o Commodity risk
  - o Volatility risk
  - o Correlation risk
  - o Liquidity risk

# IC Report:

## Best Practices – Risk Management

### 3. Investment Risks contd.

- Be familiar with forms of Other Investment Risks:
  - o Basis risk
  - o Common holder risk
  - o Event risks
  - o Counterparty risk
  - o Asset/liability matching risk
  - o Meta risks

# IC Report:

## Best Practices – Risk Management

### 4. Liquidity and Leverage Risk

- Understand the manager's definition of leverage as well as which investment strategies and instruments utilized by the hedge fund will generate levered exposure
- Monitor leverage on a regular basis and understand hedge fund managers' plans for reducing leverage if limits are exceeded
- Clearly understand the source of leverage capital in any investment strategy and understand the restrictions on continued availability of financing and alternatives available to replace existing leverage financing in case of market dislocation or problems with an existing leverage provider

# IC Report: Best Practices – Risk Management

## 4. Liquidity and Leverage Risk contd.

- Obtain information outlining how frequently managers conduct liquidity stress-testing and scenario analysis, and understand its scope
- Understand the liquidity terms of their investment in the context of the fund's underlying asset liquidity and redemption policy, and be satisfied that those terms are fair and reasonable in light of the investor's objectives
- Recognize the circumstances in which a fund can suspend redemptions and understand the measures that managers employ to mitigate the risk of such suspensions

# IC Report: Best Practices – Risk Management

## 5. Management of Risk Limits

- Be familiar and comfortable with the hedge fund manager's decision-making policies and procedures for addressing situations in which hard or soft risk limits or guidelines are exceeded
- Risk limit policies and procedures should state clearly who has the decision-making authority to address the breach of a hard or soft risk limit
  - Ideally, decision-makers are independent of the standard investment process
- Risk limit policies and procedures should provide for timely notification to investors and responsive action in the event that risk limits are materially breached

# IC Report: Best Practices – Risk Management

## 6. Compliance

- Review hedge fund managers' written compliance manuals
- Verify that the compliance function is robust, appropriately independent, and supported with sufficient resources and authority
- Be comfortable that manager's reporting requirements to investors in the case of serious compliance breaches is sufficient to enable investors to protect their interests

# IC Report: Best Practices – Risk Management

## 7. Operational and Business Risks

- Understand who has authority over the operational functions of the hedge fund
- Be comfortable that operational functions are appropriately independent from portfolio management to mitigate potential conflicts of interest
  - Conflicts likely to arise in areas of valuation, risk management and compliance
  - For smaller hedge funds without sufficient resources to separate the operational function from portfolio management, investors should ascertain how the manager intends to address potential conflicts

# IC Report: Best Practices – Risk Management

## 8. Prime Broker and Other Counterparties

- Be aware of the prime broker(s) and other material credit or trading counterparties of the hedge fund, and understand the manager's process for analyzing and diversifying prime broker and counterparty risk

# IC Report: Best Practices – Risk Management

## 9. Fraud and Other Crime

- Take reasonable steps to confirm that
  - o Manager maintains anti-money laundering procedures
  - o Fund's net asset value statements are sent to the investor directly from the independent administrator
  - o Assets are held away from the manager
  - o Sufficient internal controls exist to prevent misuse or theft of client money
  - o Fund has a robust and reasonably independent compliance function
- If foregoing not in place, the investor should confirm that there are sound and beneficial reasons for doing so and that the fund and its manager maintain appropriate procedures, controls and segregation of duties in carrying out those functions

# IC Report: Best Practices – Risk Management

## 10. Information Technology and Business Recovery

- Take reasonable steps to verify that a fund has robust business recovery and information technology plans
- Verify the fund has comprehensive policies and procedures to ensure that unexpected events do not interfere with the fund's operation
  - Be appropriate for the size, complexity, and trading volume of the fund
  - Address weather and geologic events that may be predictable in the locations where the fund has offices

# IC Report: Best Practices – Risk Management

## 11. Conflicts of Interest

- Understand the full scope of the advisor's activities, including types of funds and accounts advised by the hedge fund manager and whether they share in allocations or investment opportunities
  - Understand the manager's outside business activities, if any
- Confirm that managers have appropriate conflict-of-interest procedures and controls in place to provide for the fair and equitable allocation of investment opportunities across different accounts, so that none is favored over another

# IC Report: Best Practices – Risk Management

## 12. Other Service Providers

- Obtain information from managers explaining the process used to select and monitor the fund's service providers
- Assess whether the fund's service providers:
  - o Have sufficient experience and independence to perform their roles effectively
  - o Are not exposed to undue influence from the manager
  - o That the compensation and other terms of service provider engagements do not give rise to potential conflicts of interest
- Independently confirm material service provider relationships

# IC Report: Best Practices – Legal and Regulatory

1. Investment Structures
2. Domicile of Hedge Fund and Investments
  - Confirm that the hedge funds in which they invest prepare financial statements in accordance with acceptable accounting standards and audited by a reputable auditing firm
  - Consider the lack of audited financial statements to present an extreme degree of risk and uncertainty with respect to a hedge fund investment
  - Understand the nature, depth, maturity and stability of the legal system in the jurisdiction where the hedge fund is domiciled, and be comfortable with the investor's ability to vindicate their legal rights

# IC Report: Best Practices – Legal and Regulatory

2. Domicile of Hedge Fund and Investments contd.
  - Seek to understand the degree of risk a fund faces from potential tax, legal or other regulatory changes, either in its registered domicile or in the jurisdictions in which it invests, and the fund's strategy for mitigating those risks when possible

# IC Report:

## Best Practices – Legal and Regulatory

### 3. Terms of Hedge Fund Investments

- Investors should examine, with an eye to determining whether their interests are adequately protected, among other terms:
  - o The degree of investment freedom afforded to the fund's manager
  - o The management and performance fees charged and how they are calculated
  - o The terms under which an investment can be redeemed including "lock-ups" and notice periods
  - o The manager's power to suspend or "gate" redemptions
  - o The expenses paid by the fund
  - o Extent of the use of "side-pockets" if any

# IC Report:

## Best Practices – Legal and Regulatory

### 3. Terms of Hedge Fund Investments contd.

- o The risk factors associated with the investment
  - o The policies regarding the calculation of NAV
  - o The scope of the manager's liability to the fund
  - o Tax implications of the fund's investments
  - o Indemnification provisions among the fund, the manager and investors
- Understand the circumstances under which the fund or its manager can modify terms of the governing documents and be comfortable with the potential ensuing risks
  - Investors in funds that offer varying liquidity terms to other investors should assess the risks and benefits attendant to such terms

# IC Report:

## Best Practices – Legal and Regulatory

### 3. Terms of Hedge Fund Investments contd.

- Investors must receive notification from the manager if other investors in the same fund are, or may be, offered different liquidity terms, whether through separate classes of interest or by “side letters”
- Investors must retain competent legal advice to aid in the understanding and negotiation of terms

# IC Report:

## Best Practices – Legal and Regulatory

### 4. Fiduciary Duties (including ERISA)

- Investors and fiduciaries responsible for assets governed by ERISA should:
  - o Consult with legal counsel familiar with ERISA before making hedge fund investments
  - o Confirm that they will receive disclosures from the hedge fund that are sufficient to enable them to comply with their duties under ERISA to oversee hedge fund investments
  - o Determine if the hedge fund manager is an ERISA fiduciary and complies with the requirements
  - o Assess whether the hedge fund manager provides assurances that it will assume fiduciary duties including loyalty and due care provided by ERISA

# IC Report: Best Practices – Legal and Regulatory

5. Registration with SEC, CFTC and other Regulators
  - Determine whether a hedge fund manager is registered with or licensed by any regulatory body
  - If registered, obtain additional information from the manager or regulator concerning the nature of the registrations and their attendant obligations, and investigate any regulatory disciplinary history

# IC Report: Best Practices – Legal and Regulatory

## 6. Rights of Other Investors / Side Letters

- Prior to investment and on a regular basis following investment, request and receive from a fund's manager all pertinent information on material terms which differ from those of other investors who have invested in the fund
- Obtain sufficient information about variations in terms to determine the consequent impact of such terms on the fund's risks – including liquidity – and expected returns

# IC Report: Best Practices – Valuation

- Verify that a fund's manager has established a written statement of valuation policies and procedures
- Determine whether proper oversight of the entire valuation process exists, especially the pricing of illiquid and other investments that are difficult to price

# IC Report: Best Practices – Fees and Expenses

- Hedge fund fees should be calculated based on audited portfolio valuations
- The hedge fund's offering documents should adequately delineate all types of potential expenses and other charges that potentially could be deducted from fund assets
- The hedge fund's offering documents should adequately describe all fee sharing arrangements, soft dollar arrangements, and any compensation or benefits that the hedge fund manager may receive from fund assets or as the result of the fund's investment activity

# IC Report: Best Practices – Fees and Expenses

- Performance fees should be calculated over a period of time that is appropriate given the volatility of the hedge fund strategy's returns and any lock-up period required by the hedge fund manager
- Investors should determine whether performance fees are subject to a "high-water mark"

# IC Report: Best Practices – Reporting

1. Reporting and Transparency
  - Employ a process to determine the sufficiency and timeliness of a fund's transparency and disclosure
2. Performance Reporting
  - Investors should develop a comprehensive approach regarding the measurement of investment performance at the aggregate portfolio level, the investment strategy level, and the manager level
    - o Addresses frequency of performance measurement
    - o Addresses benchmark performance and alpha performance
    - o Addresses volatility of total return and alpha performance

# IC Report: Best Practices – Reporting

## 2. Performance Reporting contd.

- Performance measurements should be based on audited financial information
- Investors should require hedge funds, as a part of their performance reporting responsibilities, to report the percentage of the portfolio in illiquid/non-marketable securities, and/or the percentage of the portfolio held in “side pocket” arrangements

*Thank you!*

# Questions?

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