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Financial
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Mr. Andrew Shrimpton / Ms. Rebecca Jones
Asset Management Sector Team / Capital Markets Sector Team
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Re: Discussion Paper 05/4, *Hedge Funds: A Discussion of Risk and Regulatory Engagement*

Dear Mr. Shrimpton and Ms. Jones:

The CFA Centre for Financial Market Integrity ("CFA Centre" or the "Centre")[1], in conjunction with its Capital Markets Policy Council (the "Council"), is pleased to comment on the Financial Services Authority's ("FSA" or the "Authority") Discussion Paper, *Hedge Funds: A discussion of risk and regulatory engagement* (the "Consultation"). The CFA Centre represents the views of investment professionals to standard setters, regulatory authorities, and legislative bodies worldwide on issues such as those that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the efficiency and integrity of global financial markets. It has recently published the Asset Manager Code of Professional Conduct (the "Code") after a lengthy and global consultation period. A primary impetus for the Code relates to the proliferation of hedge funds, both regulated and unregulated around the world.

General Comments

In the Consultation, the Authority suggests it may enhance its risk-based approach to monitoring the risks associated with hedge funds ("Hedge Funds") and hedge fund managers ("Hedge Fund Managers") by including some or all of the following actions:

- Increased reviews of Hedge Fund Managers on the basis of investment strategy
- Improved standards for due diligence for financial counterparties such as prime brokers or commercial banks transacting directly with Hedge Funds and Hedge Fund Managers ("Financial Counterparties")
- Improved Hedge Fund Manager disclosure standards

[1] The CFA Centre for Financial Market Integrity is a part of CFA Institute. With headquarters in Charlottesville, Virginia, USA, and regional offices in London, Hong Kong, and New York, CFA Institute, is a global, non-profit professional association of more than 73,000 financial analysts, portfolio managers, and other investment professionals in 119 countries and territories of which more than 64,000 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 132 Member Societies and Chapters in 53 countries and territories.

- Requiring Financial Counterparties to identify Hedge Fund Managers as trade counterparties
- Increased proactive surveillance of Financial Counterparties and Hedge Funds on market conduct
- Improved data collection
- Distinguish between
  - Hedge Fund Managers and managers of other investment vehicles
  - Prime brokers and other brokers
- Improved Hedge Fund disclosures
- More standard Hedge Fund valuation methodologies

The Centre supports this risk-based approach as having the highest likelihood of determining which Hedge Funds and Hedge Fund Managers may pose the largest systemic risk to the U.K. financial markets. In particular, by directing Financial Counterparties to improve their due diligence, the Authority could promote a market-based – supported by regulatory prodding – solution to the risks created by Hedge Funds. In particular, it may cause these firms to take appropriate care in understanding the risks and capital costs prior to transacting with Hedge Funds and Hedge Fund Managers.

The Centre also supports the Authority's proposal to create its own centre for Hedge Fund Manager oversight. Such a centre should enable the FSA to develop a level of expertise about the industry, its trading methodologies, and hedging/leveraging activities to recognize which might create market-wide problems.

Finally, the Centre supports efforts by the Authority to encourage better disclosures and more standard valuation methods for Hedge Funds. Indeed, if Hedge Fund Managers were to adopt rules of conduct such as those included in the Centre's Code[2], it would eliminate many of the concerns implied in the Consultation. Nonetheless, for such codes to succeed they need both independent verification and enforcement.

In general, the best means of providing support for adherence to such a code is to provide regular and frequent disclosures about Hedge Fund Manager activities and Hedge Fund positions, both in the form of monthly or quarterly reports and audited annual financial statements to investors. The Authority should stand ready to revoke a Hedge Fund Manager's ability to operate in the U.K. market if it fails to abide by such a code.

Data to Collect

The Centre supports enhanced data collection of the type suggested in paragraphs 3.71 through 3.73 of the Consultation, particularly as it relates to gross long and short positions per Hedge Fund, and asset valuations from internal and external sources. This information, combined with

[2] http://www.cfainstitute.org/cfacentre/positions/pdf/asset_manager_code.pdf

the enhanced risk management and due diligence activities of the Financial Counterparties should help the Authority better understand the dynamics of the market.

The Centre believes that the FSA should pay particular attention to the following types of information when performing reviews of Hedge Fund Managers and Financial Counterparties:

- Hedge Fund Positions — These positions would include long and short positions in listed and over-the-counter securities and derivative instruments. The Authority also should pay attention to the counterparty exposures of the Hedge Funds under management. Such reviews should provide insights into the Hedge Fund Manager's valuation methodologies, and the Hedge Fund's counterparty exposures and leverage. In those cases where the Authority wants to verify positions and valuations it could look to relevant Financial Counterparties for over-the-counter derivatives, contracts for difference, or listed securities. It also could look to the central counterparties of derivatives exchanges for exchange-traded derivative contracts.
- Cash loans — If needed, the Authority could verify the Hedge Fund Manager's disclosures with the commercial or investment banks providing the loans.

Finally, the Centre encourages continuation of the Authority's cooperative and communicative efforts with other national regulators to obtain a more comprehensive understanding of the risks to global capital markets created by Hedge Funds and Hedge Fund Managers. Such communication will allow global regulators to overcome the narrow view of the activities of Hedge Funds within their own jurisdictions.

Responses to Specific Questions

Q 1: Are the risks to our statutory objectives outlined in this paper the correct ones? These risks include: serious market disruption; an erosion of confidence in the financial strength of Hedge Funds and/or their counterparties; a significant liquidity mismatch leading to enforced asset disposals and disorderly markets; insufficient information to inform regulatory action; significant control, operational and potentially credit risks; weaknesses in risk management; ill-informed investment decisions and detriment to market confidence as a consequence of valuation weaknesses; market abuse by Hedge Funds or their counterparties; fraud; money laundering; and conflicts of interest.

The Centre believes the risks noted in this question and in the Consultation cover the vast majority of the risks associated with Hedge Funds that are marketed to Sophisticated Investors. Please see our response to DP 16 - Hedge Funds for a discussion of the additional risks retail investors would face if Hedge Funds were marketed to them.

The Centre notes that there are two risks not covered by the Consultation that the Authority should consider. First is the economic leverage used by individuals and firms to invest in already leveraged funds of hedge funds.

More importantly, the proprietary trading desks of insurance companies, commercial banks, and investment banks often act in a manner similar to Hedge Funds and can incur risks similar to those in Hedge Funds. It is imperative for the Authority, therefore, to ensure that these firms have risk management systems appropriate to the types of risks that they incur from these activities. It also is imperative that these firms have systems and safeguards in place to ensure that they do not use the information obtained through their brokerage activities to create an unfair market advantage for themselves.

Q 2: In addition to the [Financial Stability Forum] and Joint Forum initiatives, are there any global or European regulatory initiatives that could helpfully raise standards in the Hedge Fund sector?

The Authority should consider the following initiatives:

- The Authority should consider the Centre's own Code when encouraging the industry to adopt a market-based code of conduct. The Code has developed specifically with the Hedge Fund industry in mind and outlines the ethical and professional responsibilities of Hedge Fund Managers. It was created with the help of its membership and other practitioners from throughout the world.
- The Authority also might wish to consider the Centre's Private Equity Provisions for the GIPS Standards[3] (the "GIPS Standards") for developing valuation standards for Hedge Fund Managers. These standards describe a hierarchy for valuation that is discussed below.
- The Counterparty Risk Management Policy Group II (the "Group") and specifically its 27 July 2005 report called, *Toward Greater Financial Stability: A Private Sector Perspective.* In this report the Group encourages the industry and market regulators to "design programs, practices and policies that can reasonably cope with very low probability financial contingencies having potentially large consequences,"[4] while not inadvertently damaging or restricting the economic benefits derived from a dynamic Hedge Fund industry. It suggests that the infrastructure to protect the industry should, where possible, be designed at the institutional level (i.e. risk management programs) or industry level (i.e. valuation guidelines) and only where necessary at a regulatory level (i.e. disclosure guidelines).

  The Group also recommends that regulation should be principals-based rather than rules-based. The reason given is that "the focus on detail inevitably can create incentives for practitioners to arbitrage the system, thereby producing the need for still more detail."

[3] http://www.cfainstitute.org/cfacentre/ips/gips/pdf/PEProvisionsFINAL.pdf
[4] http://www.crmpolicygroup.org/docs/CRMPG-II.pdf

- Another relevant report is the *2005 Sound Practices for Managers*[5] published by the Managed Funds Association. In particular, Appendix II: "U.S. Regulatory Filings by Managers" and Appendix III: "MFA Preliminary Guidance for Funds and Managers on Developing Anti-Money Laundering Programs"
- The International Association of Financial Engineers has published a paper called, *Valuation Concepts for Investment Companies and Financial Institutions and Their Stakeholders*[6]. It identifies 29 principles for valuation[7] and recommends 12 general questions investors should consider during due diligence.

Q3: Recognising the importance of stress testing as a risk management tool, do you believe that it is sufficiently embedded within the hedge fund sector and should the FSA take any steps to further encourage such practice?

The Centre is not aware whether the Hedge Fund sector's implementation of stress testing is sufficient for risk management purposes. However, while recognising that stress testing is the state of the art in measuring the effects of market aberrations on a portfolio, the Centre is not completely convinced of the applicability of stress testing in all cases.

Some researchers have concluded that while standard risk management measures work well for traditional long-only investment strategies they may fail when unstable correlations are present.[8] It is equally important to consider that stress-testing is based on past correlations, while future correlations may change and, as a result, cannot be stress-tested.

Nonetheless, the Centre believes the Authority should encourage Hedge Fund Managers and Financial Counterparties to perform stress testing or other appropriate risk management practices. The Centre also encourages the Authority to consider adopting principles for such risk management requirements rather than specific methodologies. In that way, such a rule would not force firms to adopt a structure that may not provide the most accurate picture of a portfolio's risk in the future.

Q4: Should the FSA make undertaking hedge fund management a notifiable event under the Handbook or are other alternatives for differentiating such firms preferable, such as requiring them to obtain a specific permission from the FSA before undertaking such activity? Are the investment techniques typically employed by Hedge Fund Managers (such as short selling, using derivatives for investment purposes and the use of economic and instrument

[5] http://www.mfainfo.org/images/PDF/MFA2005SoundPracticesPublished.pdf

[6] http://www.iafe.org/upload/IAFEValuationConcepts0604.pdf

[7] International Association of Financial Engineers, Risk Management Committee, Valuation Concepts for Investment Companies and Financial Institutions and Their Stakeholders, 8 June 2004, p. 4. A footnote to the *Valuation Principles* section notes that many of the suggested principles were influenced by IOSCO, http://www.iosco.org/pubdocs/pdf/IOSCOPD91.pdf and the AICPA, *Guide to Audits of Investment Companies*.

[8] N. Chan, M. Getmansky, S. Haas, A.W. Lo, *Systemic Risk and Hedge Funds*, NBER Working Paper 11200, March 2005, p. 13.

leverage), and not issues of legal structure, the optimal characteristics on which to base any definition?

The Centre supports the FSA’s proposal to make undertaking Hedge Fund management a notifiable event, as there is plenty of precedent for doing so. Those who undertake long-only asset management must notify the Authority of their intentions, and beginning in 2006 Hedge Funds (with certain exceptions) will have to notify the U.S. Securities and Exchange Commission by registering under the Investment Advisers Act of 1940, a proposal the Centre also supported.[9]

In part we support notification because it does not risk interfering with the dynamism and creativity of the marketplace even while it alerts regulatory authorities that a Hedge Fund Manager is engaging in such activities.

The Centre would discourage the Authority from using either a legal structure or investment techniques as the basis for identifying certain investment characteristics of a Hedge Fund. It is entirely likely that a legal-structure system would lead a Hedge Fund Manager engaged in highly risky investment strategies to adopt a legal structure that the FSA has identified as requiring less scrutiny. Likewise, a system focused on investment techniques could become outdated due to advances in investment strategies and investment vehicles.

The Centre believes a more appropriate measure for triggering either a notification or specific permission requirement would be to focus on the number of investors and/or the amount of assets under a Hedge Fund Manager’s control. The Authority might include a further stipulation calling for notification when engaging in a form of collective investment management that is not already subject to FSA regulation. This focus should ensure that those Hedge Fund Managers who pose the greatest risk to U.K. financial markets participants are identified.

Q5: Should we also consider differentiating prime brokers from other types of regulated entity by creating a notifiable event under the Handbook or are other alternatives for differentiating such firms preferable, such as requiring them to obtain a specific permission from the FSA before undertaking such activity?

As noted above, the Centre believes that to be effective in monitoring the activities of Hedge Funds the FSA must pay close attention to the activities of regulated entities such as Financial Counterparties. Such oversight is particularly important considering that more financial intermediaries are competing in the prime broker market.

However, Financial Counterparties who engage in prime brokerage activities are regulated by the Authority already, and it is likely that most, if not all, collect much of the information noted as important in the Consultation. Therefore, the Centre believes that a better approach to monitoring these firms’ Hedge Fund-related activities would be for the Authority to request any

[9] Please see the Centre’s response to the SEC’s proposal at CFA Centre's Response to SEC Hedge Fund Registration Proposal.

additional information deemed appropriate and necessary, rather than differentiating and possibly creating a new regulatory regime for prime brokerage activities.

Q6: Recognising that in assessing potential new regulatory initiatives, the FSA will take into account the regulatory burden imposed on firms and its effect on the competitive position of the UK, what are your views on the optimal scope of enhanced ongoing supervision (focused on market issues) of those hedge fund managers who manage funds with a significant market impact and the methodology for identifying such firms?

The Centre believes the Authority has proposed a reasonable method for supervising the activities of the industry. This includes first notification of Hedge Fund Managers' intention to undertake Hedge Fund activities, along with the Authority's existing oversight of Hedge Fund Managers. This is to be supplemented by improved due diligence requirements for Financial Counterparties that are aimed at enabling these institutions to recognize risks associated with Hedge Funds and their managers. Finally, if the Authority determines that a Financial Counterparty has significant exposure to one or more Hedge Funds, it could use its existing regulatory authority to require increased capital reserves against those exposures.

Q7: Recognising that the FSA would take into account the costs and benefits of additional data collection, do you have any suggestions about the optimal data set to be collected from Hedge Fund Managers and could you indicate the likely costs involved in its production?

The Centre believes the most relevant data would include information about a Hedge Fund's positions, its leverage, valuations and relevant assumptions, and counterparty exposures. The best source for this information is the Hedge Fund Manager.

Nonetheless, not all Hedge Funds have the staffing needed to track and report such information. Some may not provide third-party verification for the information, such as through the use of an independent third-party auditor, or such verification may be conflicted. In particular cases of concern, the Authority could seek to verify the information received from Hedge Fund Managers with the relevant Financial Counterparties.

As for the costs relating to such data collections, it is likely that most Hedge Fund Managers who have sufficient assets under management to warrant FSA notification (please see response to Q4 above) already collect this information, if only for internal purposes. Therefore, it is likely that any cost related to this aspect of data collection will be minimal.

On the other hand, Hedge Fund Managers may incur more costs when it comes to valuation of illiquid and infrequently traded securities and derivative securities. In these cases, the Hedge Fund Manager would have to obtain an appraisal which, depending on the size of the Hedge Fund's unlisted holdings and the diligence of the appraiser, could add to the costs of reporting.

Q8: Should the FSA encourage industry initiatives to improve investor due diligence and best practice as it relates to disclosure? Are there any alternative regulatory actions that should be pursued in this area, for example would you consider it helpful to receive FSA guidance in relation to disclosure, particularly in relation to side letters and managed accounts?

For investors to understand the risks inherent in Hedge Fund investments they must first have access to relevant information and, second possess the competence to review and understand that information as part of their ongoing investment analyses either directly or through their agent. Hedge Fund Managers should make such information readily available to investors or their agents. Therefore, the Centre would support the Authority providing Hedge Fund Managers with guidance on disclosures such as those relating to side letters and managed accounts.

The Centre suggests that the Authority consider using or applying the Code to provide the guidance suggested by this question. Integral to the Code is a list of disclosures relating to conflicts of interest, regulatory actions against the Hedge Fund Manager, the investment process, management fees, fund performance, valuation methodologies, use of soft commissions, and others. This list should help investors know what to request from their Hedge Fund Managers. It also should serve as a guide to Hedge Fund Managers on the kinds of disclosures they should make to their investors.

If such a code of conduct is adopted, the Authority should stand ready to revoke a Hedge Fund Manager's ability to operate in the U.K. market if it fails to abide by the code's requirements.

Q9: Do you believe that regulatory action is required with respect to hedge fund valuation? If so, should this aim to stimulate voluntary industry improvements or be more rules based? Should the FSA seek to encourage improvements purely in a domestic context or would international initiatives be more effective? Are there any specific forms of regulatory action that you would recommend?

Hedge Fund valuations are one of the key components to enabling investors to properly assess the risks associated with a Hedge Fund. It is also the area most fraught with potential for abuse as reflected in recent hedge fund scandals. Such valuations include a variety of assumptions, even when based on the market prices of highly liquid securities. As a consequence, it is vital for investors to receive not only the valuations of portfolio holdings, but also disclosures regarding what assumptions the Hedge Fund Manager used in calculating those valuations.

The Centre believes its Code can be helpful in this regard, as well. It calls on Hedge Fund Managers to "use fair market prices to value client holdings and apply, in good faith, methods to determine the fair value of any securities for which no readily available, independent, third-party market quotation is available." Such considerations are particularly relevant given that Hedge Fund Managers' remuneration often is based on a combination of assets under management and changes in value of the Hedge Fund. It also suggests that Hedge Fund Managers overcome these conflicts of interest by transferring responsibility for valuation to an independent third party.

Standards for valuation should require firms to define what is meant by value, the moment in time the valuation is made, and the specific methodology and assumptions used. They should be flexible enough to encompass the development of new methodologies, while limiting the options for Hedge Fund Managers to work around them. Hedge Fund Managers also should disclose changes in valuation methodology, including reasons and reconciliation (if practicable), in advance of such changes and offer the right of redemption to investors who are not in agreement.

The standards should take a hierarchical approach to valuation similar to that used in the Centre's "Private Equity Valuation Principles," included as Appendix A to the GIPS Standards. This approach looks for directly comparable market transactions as the preferred valuation method. If none of these are present, it calls for application of market-based pricing multiples to the cash flows of the specific investment being valued. Finally, in the case of securities with little or no activity or market comparables, the Hedge Fund Manager would value the investments by discounting expected future cash flows. Regardless of the method used, however, the Hedge Fund Manager should disclose all the assumptions included in the calculation.

Ultimately, any valuation requires verification. In the case of publicly traded securities, corroboration is easily found given the data available from a variety of sources. However, valuation of non-publicly traded or private placement of securities will cause more difficulties for investors. The use of third parties to "audit" or assess the validity of the models and assumptions provides benefits to investors, so long as such auditors are truly independent.

Q10: Should the FSA and/or international regulatory bodies encourage the development of a hedge fund code of conduct? What would be the optimal method for facilitating such a development? Are there any particular risks in relation to which such a code could obviate the need for regulatory action?

The Centre supports the use of an industry-developed and enforced code of conduct and has already developed such a code, as noted in the preceding questions, which has been endorsed by many in the industry. The Code was created specifically with Hedge Fund Managers in mind and is attached as an exhibit to this response for your review.

Closing Remarks

The CFA Centre for Financial Market Integrity, together with its Capital Markets Policy Council appreciates the opportunity to provide comment to the FSA on its Discussion Paper 05/4, *Hedge Funds: A Discussion of Risk and Regulatory Engagement.* If you or your staff have questions or seek amplification of our views, please feel free to contact James C. Allen, CFA, by phone at +1.434.951.5558 or by e-mail at james.allen@cfainstitute.org.

Sincerely,

/s/ Frederic P. Lebel	*/s/ James C. Allen*
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Encl.