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Mr. Russell Read, CFA
Chair
Investors' Practices Committee
President's Working Group on Financial Markets
c/o CalPERS
P.O. Box 2749
Sacremento, CA 95812-2749

Re: *Principles and Practices for Hedge Fund Investors*

Dear Mr. Read:

The CFA Institute Centre for Financial Market Integrity (the "Centre")[1] appreciates the opportunity to comment and congratulates the Investors' Practices Committee (the "Committee") of the President's Working Group on Financial Markets (the "PWG") for its report, *Principles and Practices for Hedge Fund Investors* (the "Report"). The growth of the hedge fund sector has been remarkable in the past several years as reflected in the fact that around 6.5% of our membership is dedicated to the hedge fund sector. As a consequence of this growth and increased investor interest, the Committee's work on this guidebook is welcomed as a comprehensive and timely review of the issues that investors need to consider.

The Centre represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues 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. As a part of this role, we seek to educate investors on a variety of topics ranging from the application of ethics in financial markets to the understanding of corporate governance, hedge funds, and other topics of interest to participants in global markets. As we recently discussed, part of these efforts relate to our developing the *Asset Manager Code of Professional Conduct* (the "Code") with the goal of providing hedge fund and other investment managers an ethical guide that is intended to help them achieve a client focus. The Code was provided to you and the Committee and is available on the Centre's web page.[2]

[1] The CFA Institute 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, not-for-profit professional association of more than 94,000 financial analysts, portfolio managers, and other investment professionals in 133 countries and territories, of whom 82,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 56 countries and territories.

[2] http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n4.4008.

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In general, the Centre supports the Committee's efforts and believes the Report will be a useful guide for investors as they consider hedge fund opportunities. Among the important issues raised is the distinction between quantifiable risks and unquantifiable uncertainties discussed in the *Fiduciary Guide* section. In particular, the discussion about investors assessing their tolerance for the greater uncertainties arising from hedge fund investments in light of their size, strategy, and objectives is an important point.

The Centre also notes the helpful nature of the *Investors' Guide* section. The information provided covers a broad spectrum of issues related to hedge fund investing in a manner that is concise and clearly written. This section should assist investors in considering the many critical issues related to making an informed investment decision.

The actions of investors have already helped improve the transparency and risk management practices of hedge fund managers. As noted in a January 2008 report from the General Accountability Office[3] (the "GAO"), institutional investors, particularly those with fiduciary responsibilities, have been instrumental in improving the quality and frequency of disclosures and the risk-management efforts of hedge fund managers. The Report should help further that effort.

Below we offer several additional ideas and suggestions for consideration as the Committee completes its work on the Report.

Fiduciary Guide

<u>Code of Conduct.</u> We would encourage you to consider suggesting that investors ask hedge fund managers if they adhere to a professional code of conduct. In particular, we support the notion that hedge fund investors would have a means of consistently comparing and contrasting managers and their services. For example, the Centre's Code, as noted above, was created specifically to help asset managers recognize their ethical and professional responsibilities toward their clients. These responsibilities include a need to communicate regularly and effectively with investment clients. Such communication should include the kinds of information described in the Report. A code of conduct, therefore, is an important element in helping fund managers build and maintain investor trust and confidence by causing them to act with loyalty, prudence and care.

<u>Fiduciary Oversight.</u> We suggest that the Report might further describe the responsibilities of fiduciaries in the list of questions raised at the beginning of the Fiduciary Guide section. We note specifically that it is important to understand and distinguish the fiduciary roles of both the actual hedge fund investor acting on behalf of clients or beneficiaries, and the hedge fund manager retained to manage assets. In the case of the former, the Centre suggests additional

[3] "Hedge Funds: Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention Is Needed." See: http://www.gao.gov/new.items/d08200.pdf.

bullet points along the lines of the following, and that it should reiterate these responsibilities throughout this section:

- *Oversight: Does the organization have appropriate policies and procedures in place to provide ongoing monitoring of hedge fund investments and hedge fund managers?*

- *Does the hedge fund investor/fiduciary take responsibility for the management of the assets and therefore seek regular and substantive communications with the hedge fund manager?*

- *Does the information provided to the fiduciary come from an independent third party such as a custodian, auditor, or outside consultant?*

Fund of Funds. The Report briefly notes investments in funds of hedge funds (FOF), first in item 4 under the Hedge Fund Investments and Allocations portion of this section. The second mention occurs in the Reporting section, and a third mention comes under the Fees section.

However, the Report provides little guidance on due diligence and monitoring for these types of investments. Nor does it discuss these instruments in much detail as a possible means of reducing risks associated with a concentration of funds with a single investment adviser. The Centre encourages some additional information and guidance in this regard.

Legal Domicile. In the discussion of the due diligence process, the Centre believes investors should consider not only the legal domicile of the investment vehicle, but also the legal domicile of the hedge fund manager. This could provide valuable information about the degree of regulatory oversight and legal recourse related to a particular investment.

Investors' Guide

Information Requests. The Report suggests that investors ask for information that relates to a number of topics prior, and subsequent to investing with hedge fund advisers. In every case, the Centre agrees with the value of such information and the requirement that an investor should request such information as part of their due diligence. Given the importance of such information, the Report might also address what investors should do if they are rebuffed in their informational requests.

In general, the Centre believes investors should seriously reconsider investing in any fund that fails to provide such information, and to convey such views to the hedge fund manager. In the penultimate paragraph to the Executive Summary, the Committee makes this point. The Committee should consider reiterating this point throughout the Report, particularly with regard to reliance on the hedge fund manager to provide critical information, and to confirm that where such information is not forthcoming, a decision to forgo an investment is a strong option.

Inability to Achieve Best Practices. In the third paragraph of this section, the Report notes that "the inability to achieve all appropriate best practices in their ideal form does not necessarily require an investor to abandon an investment opportunity." The Report goes on to suggest that this would indicate a situation of "increased risk," and that any "investment decision should reflect the appropriate consideration of this incremental risk."

While the Centre agrees that it is unlikely that each investment opportunity will achieve all best practice guidelines, it is nevertheless important that investors consider such shortcomings seriously. The Report noted earlier that the actions and requests of institutional investors have encouraged hedge fund managers to improve their disclosure and risk management processes. We think a similar opportunity exists here. The Committee could more forcefully note the serious nature of such lapses, and that continued pressure on hedge fund managers for transparency, may encourage further compliance with accepted best practices.

Investment Performance. The Centre endorses the use of global industry standards for reporting performance. This is one of the few ways of consistently comparing performance of fund managers. We note the Global Investment Performance Standards ("GIPS") created by CFA Institute as one example of the level and accuracy of information that investors could request from their hedge fund managers. Investment performance reporting requirements noted here in item number 3, are also relevant in item 1 under "Reporting."

Hedge Fund Registration. Under "Legal and Regulatory," the Report notes the unregistered nature of many hedge funds. It would be appropriate to alert potential investors to the fact that nearly 2,000 hedge funds are registered with the Securities and Exchange Commission, including many of the largest hedge fund managers. These funds handle nearly one-third of all hedge fund assets under management in the United States. This information could help direct more risk-averse investors to the possibility of investing with a manager that is registered.

Conclusion

The Centre supports the Report's findings, and also its view that continuous investor vigilance is needed. The Centre welcomes the opportunity to comment and is prepared to assist the Committee as it completes its work. We offer the insights and experience of the estimated 6.5% of our more than 94,000 professional members that are dedicated to the hedge fund sector. Please feel free to contact us: Kurt Schacht, CFA, at +1.212.756.7728 (kurt.schacht@cfainstitute.org), Jon Stokes at 1.434.951.5314 (jon.stokes@cfainstitute.org)

Sincerely,

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