Setting the global standard for investment professionals

16 May 2008

Mr. Eric Mindich
Chair
Asset Managers' Committee
President's Working Group on Financial Markets

Via Internet

Re: Best Practices for the Hedge Fund Industry

Dear Mr. Mindich:

The CFA Institute Centre for Financial Market Integrity (the "Centre")[1] would like to congratulate the Asset Managers' Committee (the "Committee") of the President's Working Group on Financial Markets (the "PWG") for its report, *Best Practices for the Hedge Fund Industry* (the "Report"), and offer the comments below. Our members, both those working in the hedge fund sector and those investing in these funds, have, in many cases, benefited from the remarkable growth in the broader sector over recent decades. As a consequence of this growth and increased investor interest, the Committee's work on this set of best practices is welcomed as a timely review of the issues that hedge fund managers 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 development of ethical and professional standards for participants in financial markets to the understanding of corporate governance, hedge funds, and other topics of interest to participants in global markets. One of these efforts is the ongoing development of our *Asset Manager Code of Professional Conduct* (the "Code"), whose goal it is to provide hedge fund and other investment managers with an ethical guide to help them sustain a client focus in all dealings. (A complimentary copy of the Code may be downloaded from the Centre's web site.[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 95,000 financial analysts, portfolio managers, and other investment professionals in 134 countries, 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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The Centre generally supports the Committee's efforts and believes the Report will be a useful guide for asset managers as they administer the operational and risk aspects of their funds. In particular, the Centre commends the Committee for placing emphasis on disclosure and investor protection by discussing relevant matters in the Report's first section. As this placement indicates, the Committee members recognize that comprehensive, timely, and consistent disclosures about investment opportunities are key to financial market confidence.

As noted below, the Centre encourages the Committee to ensure that this set of "best practices" includes additional consideration of investor views as a means of accomplishing the ultimate goal of any self-regulation initiative. In particular, the right approach is to create a comprehensive set of ethical and professional industry standards that hedge fund managers will adopt in entirety, and to which they can then claim compliance. This is far preferable to merely providing a laundry list of practices from which hedge fund managers may select without requiring manager adoption of or compliance with the full list.

When managers are free to pick and choose among the recommendations with which they can or want to comply, it inevitably leads to a variable compliance, thereby prohibiting easy comparison, a standard set of requirements, or a decent opportunity for investors to determine a manager's true professional and ethical framework. Further, based on our extensive experience with administering the Global Investment Performance Standards (GIPS®), we can testify that partial adherence to or variable adoption of standards defeats the purpose of consistent application and makes enforcement impossible. We are concerned that without a comprehensive code, created with strong investor protection provisions that require full adoption, these kinds of flexible best practice guidelines create only the veneer of self-regulation.

In the view of the Centre, the hedge fund sector is facing increasing calls for regulation in part because it fails to take investor interests and market integrity issues seriously. Later in this letter, we point out that while the Report does note the primacy of investor interests, it does so only in a parenthetical phrase located in a sub-point in the last section, eight pages from the end. We are concerned with what such placement conveys about investor interests.

Certainly, investor interests already are playing a bigger role in the hedge fund industry, as described in a February report from the U.S. General Accountability Office (the "GAO Report"). The GAO Report notes the influence of pension funds, in particular, on the transparency and practices of the hedge fund industry, adding, though, that the industry needs to do more.

To overcome the calls for increased regulation, both in the United States and abroad, the hedge fund industry will have to take steps toward creating a single global set of ethical principles and standards that hedge fund managers must adopt in their entirety to claim compliance. Such principles and standards will need to address the primary concerns of hedge fund investors, namely:

- The need to act in a professional and ethical manner at all times;

- The need to act for the benefit of clients;
- The need to act with independence and objectivity;
- The need to act with skill, competence, and diligence;
- The need to communicate with clients in a timely, accurate, and effectual manner, and
- The need to uphold the rules governing capital markets.

This list embodies the General Principles of Conduct contained in the Centre's *Asset Manager Code of Professional Conduct* (the "AMC").

Aside from the fundamental changes and alternative approach to establishing manager best practices as noted above, the remainder of this letter describes specific elements of the Report that relate to investor concerns and deal with improved ethical and operational standards.

Disclosures, Compliance, and Ethical Standards

Priority of Clients' Interests. The Centre commends the Committee for raising the issue of the priority of clients' interests over those of the fund manager and its employees. This is an issue that other, similar initiatives have ignored. The Centre believes that the primacy of client interests should permeate, among other issues, all considerations relating to how a fund's assets are invested, what information is conveyed to investors and significant counterparties, and how individual investment instruments and portfolios are valued.

While the Report raises some of these issues, we are concerned that the reference to the priority of investor interests appears only in a parenthetical reference near the very back of the Report (page 43 of 51). Unfortunately, relegating this issue in such a manner may reinforce the perspective of any fund managers who already are inclined to make client interests a secondary concern.

To remedy any misperception, the Centre suggests three fundamental changes to the Report. First, move the discussion to a more prominent spot at or near the beginning of the Report to convey the ranking of investor interests above all other considerations. Second, in a separate, dedicated section, discuss more thoroughly the reasons why client interests should have priority over those of the manager and its employees. And third, incorporate the investor's perspective as a fundamental element of all chapters, but particularly in the chapter on disclosure and investor protection.

Code of Ethics. At the end of the first paragraph of Part II under the Code of Ethics section, the Committee states that policies or subjects addressed in the code of ethics or compliance manual "should be determined by the Manager taking into account what it believes is most effective for its business." The implication of this statement is that ethical standards should adhere to or be driven by the manager's business imperatives. Several foundational principles are necessary to define any good ethical framework.

As creator and administrator of the *CFA Institute Code of Ethics* and *Standards of Professional Conduct*,[3] industry standards followed by nearly 100,000 investment professionals around the globe, the Centre fully understands the role that codes of ethics and professional standards play in how individuals act and perceive their responsibilities. In particular, such standards are intended to convey the values that will guide a firm or organization as it goes about its mission and to create a tone for how the firm's employees should act and perceive their roles. The Report's suggestion that an asset manager base its code on what "is most effective for its business" may quickly undermine the purpose and value of such a code of ethics.

The Centre believes the Committee should restate its position to say that a code of ethics should work to place the interests of investors and the integrity of financial markets ahead of the manager's interests for the long-term benefit of all parties. Moreover, the code should apply to all the fund's employees rather than only to certain identified individuals (Part II, Code of Ethics, paragraph 3, page 44).

Finally, the Report states (in the same section and page, but in paragraph 5) that employees "should certify that they have read the code of ethics and *undertake to behave* in conformity with it [emphasis added]." Again, the language used diminishes the perceived importance of the practice because it appears to suggest that *trying* to behave in conformity with the code is all that is required. To remedy this ambiguity, the Centre suggests restating this passage to read that employees "will act in conformity" with the code.

The Centre believes that such revisions will enhance the quality of managers' codes, thus ensuring that fund managers and their employees will understand how and why they should comply with the codes.

Soft Commissions. In Part III.A.3.c(vi) (page 45), the Report calls on asset managers to ensure "that the use of soft dollars is consistent with what has been disclosed to investors." Soft dollars represent assets that are generated from client assets and, therefore, the Centre believes they should be used solely for the benefit of clients, not for the benefit of the manager. All disclosures, both in offering memoranda and in on-going disclosures, should conform to this principle.

Material Non-Public Information. Finally, the Report describes in Part III.A.3.c(ix) that funds should develop policies "and procedures designed to prevent obtaining material non-public information while conducting research and information gathering when investing in public companies." While policies and procedures are needed to prevent fund employees from obtaining such information, the Centre believes that the Report also needs to provide policies and procedures to guide employees should they inadvertently come across material, non-public information. In particular, the policies and procedures should unequivocally state that employees

[3] http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2005.n3.4000.

should not act, or cause others to act, upon material, non-public, "inside information" before it is available to the market.[4]

Disclosures

While the Centre supports the general thrust of the Report's suggested disclosure practices, we are disappointed that these practices are typically provided as qualified suggestions rather than as requirements to claim compliance with these best practices. For instance, in paragraph 2 under "Disclosure Material Information to Investors" (page 2), the Report indicates that private placement memorandums ("PPMs") "should be updated or supplemented when a material change occurs that makes the PPM materially inaccurate…" The Centre believes the PPM should be updated both on a regular basis, regardless of events, and when material events occur. Such information as performance reports (see discussion below), changes in assets under management, or diversification into new but related markets, may not be considered "material changes" by the manager, yet could have important bearing for an individual or institution considering an investment in the fund. Without regular updates to the PPM, investors may find themselves investing in funds on the basis of outdated and therefore faulty information.

Likewise, in the bullet point under paragraph (f)(ii) under "Ongoing Disclosures" (page 8), the Report notes that, "Depending on the circumstances, the following are types of information that should, when material, be disclosed to investors promptly after occurrence." The list includes changes to valuation policies, changes in key personnel and disciplinary histories, new side letters, fraud, and other potentially adverse operational issues. The Centre contends that investors would find all matters in the list material and encourages full disclosure as a regular practice, rather than on a variable basis. In qualifying the best practice to allow fund managers to disclose this information only if they believe unspecified circumstances warrant it, the Report is providing fund managers with a justification for withholding such information. If a fund manager is to claim compliance with this set of best practices, there should not be a dilution of adherence to or consistency in the practices; we suggest that the Committee remove the materiality clause from the suggested practice.

Finally, in various sections of the Report, managers are urged to make certain disclosures, but only if the disclosure will not compromise the fund's competitive position or its ability to manage its portfolio (item 1(a), and third bullet point of item 2(f)(ii), both under "Ongoing Disclosures). The Centre finds such reminders peculiar, particularly in recognition that most concerns about hedge fund disclosures relate to the failure to disclose enough information rather than to disclose too much information. By qualifying the practice in this way, the Report seems to permit endless variation in levels of disclosure of relevant and material matters that may have considerable importance to investors. Ultimately, this reinforces the unacceptable perception that

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[4] The Centre recently advocated on behalf of retaining a higher regulatory standard with regard to dealing with inside information in the United Kingdom. See http://www.cfainstitute.org/centre/topics/comment/2008/pdf/hmt_market_abuse.pdf.

the interests of fund managers come before those of fund investors. We suggest that such discussions can be safely removed from the Report without creating a significant risk of fund mangers conveying information to their investors or significant counterparties that may impair their competitive positions.

Performance Reporting

When discussing the issue of performance reporting, the Report focuses specifically on audited financial statements and the manager's discussion and analysis of this performance. What it does not provide, either in the discussion of ongoing disclosures or in the discussion about disclosures to include in the PPM, is any discussion about reporting on investment performance. In particular, the Report does not provide any indication of how fund managers should report such performance and whether they should make such reports consistent with both previous reports from the managers, and with similar reports provided by other managers. The Centre believes this, too, is an important oversight on the part of the Committee and one that should be remedied.

To remedy this omission, the Centre suggests that the Report encourage fund managers to comply with the Global Investment Performance Standards® (GIPS®). These standards, developed by CFA Institute 20 years ago, are now considered best practice and used commonly throughout the world. By endorsing a global standard such as the GIPS standards, the Report would proactively put the interests of investors before those of the funds' managers by allowing them to make apples-to-apples comparisons of performance across different firms.

Conclusion

The Centre commends the Committee for its work to raise the professional standards of hedge fund managers. The Centre welcomes the opportunity to comment and is prepared to assist the Committee as it completes its work based on the ethical perspectives of our more than 95,000 professional members, many of whom either work or invest in the hedge fund sector. Please feel free to contact us. Kurt Schacht, CFA, at +1.212.756.7728 (kurt.schacht@cfainstitute.org), or James C. Allen at +1.434.951.5558 (james.allen@cfainstitute.org)

Sincerely,

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