



**A GUIDE TO INSTITUTIONAL INVESTORS'  
VIEWS AND PREFERENCES REGARDING  
HEDGE FUND OPERATIONAL  
INFRASTRUCTURES**

*AIMA INVESTOR STEERING COMMITTEE*

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# A Guide to Institutional Investors' Views and Preferences Regarding Hedge Fund Operational Infrastructures

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## Foreword

AIMA is very pleased to publish this paper, outlining institutional investor views regarding a number of important areas of operational and organisational "infrastructure", which are receiving increased industry focus. AIMA has supported and provided publications related to a wide variety of educational guides and sound practices throughout its 20 year history. In light of the ongoing "institutionalisation" of the hedge fund industry and the growth of institutional investor participation, we hope that this paper, authored by some of the most influential investors and advisors in the industry, will be a useful reference to both investment managers and investors.

The idea for this paper came from discussions within the AIMA Investor Steering Committee ("ISC" hereafter), a group of experienced hedge fund investors from across the globe, regarding a variety of public and private sector initiatives following the crisis. Of course, such initiatives include the increased regulatory oversight of hedge fund managers, but they also took account of a number of private sector initiatives driven by investors and designed to improve transparency, alignment and governance. In many respects, these initiatives are quite distinct from the regulatory agenda and may have a greater influence on how the industry, investors and managers operate going forward. As such, the ISC decided to publish this paper in order to outline investor views, expectations and preferences regarding a variety of important operational and organisational issues, which are increasingly the focus of due diligence reviews and discussions among investors and fund managers.

At AIMA, we have observed the "institutionalisation" of the hedge fund industry throughout the past decade. In its earliest stages, this trend was evidenced by the increasing annual flows of new capital from institutional investors (i.e., public and private pensions, insurers, foundations and endowments and, more recently, sovereign wealth funds) into hedge funds and funds of hedge funds. However, during the past few years, institutional investor capital has become the absolute majority within the industry and, based on analysts' estimates, is expected to continue to grow significantly during the next several years. Whether to attract such capital or in response to increased institutional investor participation, the operational practices of hedge fund firms have evolved as well. Today, we observe a larger number of non-trading professionals within firms, as well as a greater focus on operational or back office systems, compliance and performance and risk reporting. These increased operational infrastructures are visible among managers of all strategies and sizes; from the large and established firms to much smaller, even start-up, managers, a more sophisticated operational framework is required to attract institutional investor capital today.

This paper has benefited from the authorship of five experienced professionals, covering five topics considered by them to be of major significance to investors. The aim is to outline, in general terms, their views and expectations with regard to these important operational and organisational issues. This is not to say that these are the only ways for managers and investors to address these topics, and we do not seek or intend to endorse any particular practice. Similar to prior AIMA publications, this paper is intended to inform our membership with the views and experiences of these industry professionals.

The paper begins with the important issue of Governance authored by Luke Dixon of Universities Superannuation Scheme (USS) and discusses the fundamental importance of good governance, key constitutional documents and the role of boards of directors. Second is Risk authored by Andrea Gentilini from Union Bancaire Privée where a variety of reporting practices, with regard to the investment portfolio, operations, counterparties and liquidity, are outlined. The third section covers Investments authored by Kurt Silberstein of the California Public Employees Retirement Scheme (CalPERS) and discusses performance reporting, terms and conditions, control of assets and transparency. The fourth section addresses Capital, authored by Michelle McGregor Smith of British Airways Pension Investment Management, and discusses issues related to a firm's ownership structure, investor relations and related sales and marketing activities. Finally, Operations, authored by Adrian Sales of Albourne, encompasses a variety of operational issues including valuation, business continuity planning, compliance and relationships with service providers.

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We wish to extend our sincere thanks to each of the authors for contributing to this paper, as well as to Tom Kehoe of AIMA (Research Manager), who skilfully coordinated the drafting of this paper throughout the process. We hope you enjoy reading the paper, and that it is useful in your investment considerations.



Todd Groome  
*(Chairpersons of AIMA Investor Steering Committee)*



Christopher Fawcett

### The Size Factor

It is very important to note that no distinction is made in this paper between small and large hedge fund managers. Institutional investors' views and expectations are outlined without regard to particular strategies or the size/budget of a manager. We acknowledge the fact that larger managers are likely to have budgets that allow them to address the points specified in this paper with greater depth and breadth. However, we also believe that there is usually a pragmatic and practical way to adhere to the principles laid out in this paper for most budgets. Awareness is the key. Smaller, or even start-up, hedge fund managers who prove to be attentive to the points mentioned here - e.g., by implementing small-scale initiatives, considering these issues as key priorities in their expansion plans, and/or by providing legal protections for an investor around control and liquidity conditions - are also going to be given credit regarding these important issues as part of an institutional due diligence and capital allocation.

The clear proof is that smaller managers are indeed eligible for and receiving institutional investment capital today. While the industry is often seen to be dominated by the larger players, new talent emerges continuously, fostered by the trust and supported by the capital of, among others, institutional investors. This is a desirable characteristic of the hedge fund industry for all participants, especially investors.

In cases where a hedge fund manager's implementation falls short of investor expectations, due to a proven lack of budget, investors and managers may agree on an investment contingent upon reaching certain operational or organisational milestones, or provide legal protections around control and redemption/liquidity conditions, as noted above. These are increasingly common practices, and have worked in the past to support early-stage investments or allocations to smaller managers.

The greatest value in considering the issues outlined and discussed in this paper, therefore, is to focus on the underlying principles, rather than on how they may be implemented by different managers. Investors desire, and increasingly expect, managers to adhere to these operational and organisational principles and practices, irrespective of their size, and investors are generally open-minded that such practices can be applicable to a variety of implementation styles and budgets.

The AIMA Investor Steering Committee (May 2011)

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## Disclaimer

*The Guide is not to be taken or treated as a substitute for specific advice, whether legal advice or otherwise. It does not seek to provide advice on any of the issues herein. The views expressed in this Guide are those of the AIMA Investor Steering Committee and do not necessarily reflect the views of AIMA itself or any of its members.*

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As authored by Luke Dixon, Universities Superannuation Scheme (USS).

## 1 GOVERNANCE

### 1.1 Relevance

The growing importance of good fund governance and, by association, high quality independent directors, is evidenced by the increasing amount of time that hedge fund investors are spending on assessing the standard of governance, when conducting their due diligence on a fund. Governance has become a “make or break” area in the investment decision-making process. Indeed, where investors believe that governance is sub-standard, they should offer suggestions for improvement.

The presence of good governance is essential in terms of both crisis mitigation and in the event that a hedge fund encounters a problem that requires a resolution. For fund investors, governance is the single most important consideration that can determine an investor's access to their capital. Poor fund governance is a significant risk for investors and one that is borne without any associated reward.

Presently, the standard of governance among hedge funds varies and this can expose investors to significant risks. The financial crisis of 2008 uncovered poor governance practices among many hedge funds which, for example, used *force majeure* considerations to impose unjustified limits on investor redemptions. In some cases, those redemption requests have yet to be honoured and filled, more than two years after the crisis abated. Other examples include failures by directors to review and appropriately approve non-arm's length dealing between a fund and its investment manager or sponsoring bank. This sometimes permitted the investment manager to engage in activity that served its interests above those of the fund's investors. This has led to the conclusion that the standard of governance of hedge funds should be improved.

The parameters of governance are set out in the fund's constitutional documents and animated by its board of directors (and that of the master fund, if applicable). The constitutional documents, which consist of its memorandum and articles of association and its offering memorandum (“OM” hereafter) (or private placement memorandum), are frequently drafted with a strong bias towards the interests of the investment manager or advisor, and offer few rights or protections to investors. Conflicts of interest frequently exist between the hedge fund's board of directors, investment managers and the fund's advisors. As the above examples illustrate, these conflicts can often lead to decisions being taken in the interests of the hedge fund's investment manager rather than in the interests of the fund and its shareholders as a whole, which is contrary to the fiduciary obligations of the fund's directors. This is an issue previously overlooked by many hedge fund investors in their due diligence of potential hedge fund investments however; today it is receiving increased scrutiny. Investors recommend that governance structures and oversight responsibilities should be in place to protect them, and, would want all oversight responsibilities to be undertaken by responsible, knowledgeable and independent fiduciaries.

This section addresses governance as it relates to the hedge fund investors' level of control over the management of the hedge fund. The principles of good governance, if not the specific structures, apply equally to offshore fund investors as well as limited partners in domestic US partnerships so the terms “investor” and “fund” will be used generically to apply to both. Those principles will, however, in some cases need to be applied differently to reflect a partnership fund vehicle.

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## 1.2 Constitutional Documents

### 1.2.1 Content

Investors expect a hedge fund's memorandum and articles of association and OM, together, to provide an effective framework for governance. The governance framework includes the voting interests of investors, the role and responsibility of the fund's board of directors, and the investment objective and strategy description (along with associated investment restrictions) contained in the fund's OM.

### 1.2.2 Requirements

Hedge fund investors should be given the option to subscribe for voting shares in the fund. Shareholders who hold such a voting share should have the right to vote on material events or changes in the fund for which shareholder approval should be sought at a general meeting. These might include the appointment and removal of the investment manager; the election of directors; approval of directors' fees; variation of shareholder rights; or a winding up of the fund at annual or extraordinary general meetings. In addition, these fund shareholders should be able to nominate directors; file a resolution at general meetings; convene an extraordinary general meeting; while the fund's registrar should facilitate investor communications, solicitations and proxies, in this respect. This is in contrast to the common offshore capital structure wherein effective control of some or all of the above are vested in "Management Shares", "Founder Shares", or some equivalent share class which is typically held directly or indirectly by the Investment Manager or its founders/partners and which has no economic interest in the assets of the fund. The establishment of a good fund governance framework ensures that the fund's investment manager is treated in a similar manner as other service providers to the fund, whilst recognising that the fund exists to provide investors with access to that specific manager's skill set.

The hedge fund's OM, where practical, should be sufficiently precise when describing the fund's investment strategy and appropriate investment restrictions, in order to serve as a guide for director and investor oversight. The fund's investment objective and strategy should contain a description of the assets that the fund intends to invest in, where (geographically) these assets may be limited and how the manager will trade them from a style perspective. Asset classes and geographical boundaries that are not included within the strategy definition should be explicitly excluded as "investment restrictions" in the fund's OM. This will provide the directors and investors with relevant reference points for monitoring the fund's exposure and investment activities. The absence of specific and granular descriptions in the objective and strategy section of the OM can lead to the lack of constraints on the investment manager's activities. This can allow too much scope to invest outside the strategy limits understood by investors, and no objectively measurable parameters for investors and directors to monitor. Moreover, the presence of strategy limits and investment restrictions have the additional benefit, from an investor's perspective, of obviating style drift which, if occurs, can limit a fund's potential asset growth.

Investors expect that the constitutional structure, governance, and rights and obligations of investors should not materially differ between a fund and a master fund into which the former may allocate capital. In some cases, a master fund may have different or even undefined redemption terms for its feeder funds that invest in and constitute its shareholders. These feeder funds should also have voting rights and the other basic investor protections compared to the master fund as those held by investors in the feeder funds. The master fund may have an inadequate board of directors. Since the assets in such a structure are held at the master fund level, investors tend to require protection at both the master fund as well as the feeder fund level. These protections will provide a reasonable and consistent mechanism to facilitate investor redemptions in any imaginable scenario.



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Investors expect that the hedge fund's constitutional documents should not contain any restrictions on the fund's directors' power to replace the fund's service providers including the investment manager. At a minimum, the fund's service providers should report directly to the hedge fund's board of directors at regular and *ad hoc* meetings of the directors. Further, investors expect information, including the fund's financial statements, to be prepared by and delivered to the directors by the fund's service providers rather than by the investment manager. This reporting distinction explicitly recognises that the service providers are contracted to the fund rather than to the investment manager. In the absence of executive officers employed by the fund, it is the fund's board of directors that is responsible for overseeing the fund's day-to-day operations and, therefore, the service providers should have a reporting obligation to those directors. This also ensures that the directors have a direct line of communication with the service providers and that information provided to them from the service providers is not filtered, initially, by the investment manager. There are a few examples of investment managers falsifying financial statements and those are less likely to have occurred if the funds' auditors were required to deliver their audit reports directly to the funds' boards. Naturally, the investment manager should maintain direct communication with the fund's service providers on a daily basis, or as necessary, to manage the fund's investment activities effectively.

Investors would like the fund constitutional documents to make the fund's directors responsible for valuation, rather than the investment manager. This does not mean that the fund's directors are responsible for valuing each of the portfolio's underlying securities, as this is subject to delegation to the fund's independent administrator or valuation agent. Rather, responsibility for valuation should ensure that it is the directors that make the final determination on price where there is a dispute between the price of a security, that is obtained independently by the fund's administrator, and the value asserted by the investment manager. In reaching their conclusion, the directors are likely to take advice from the fund's administrator, the investment manager and any third party sources that they deem appropriate. Security pricing should not be left to the discretion of the investment manager.

Investors would also like to see that decisions to invoke fund gating mechanisms and side pockets, or to suspend fund redemptions and net asset value ("NAV" hereafter) calculations, to be also the responsibility of the board of directors. Additionally, ideally the board should be permitted to negotiate at arm's length with the investment manager on any fees to be charged on assets reasonably withheld from redemption (that is those assets where, at extremis, there is no bid or such poor liquidity as to make liquidation of them impractical). In arriving at these decisions, the directors should carefully consider the interests of all investors, which may differ materially between those investors requiring an immediate redemption and those desiring to remain invested in the fund. The interests of the investment manager are tertiary and subsidiary to the interests of outgoing and remaining investors. The fund's directors, therefore, should consider carefully the investment manager's conflict of interest, when taking the latter's advice with regard to invoking redemption restrictions and fees on assets withheld from redemption.

Whether the fund's structure is an offshore master-feeder, as described above, a domestic partnership or a hybrid of corporate and partnership structures, the investment manager should be cognizant of investor rights and protections and ensure that these are maintained as investor capital transits the structure. It is insufficient and superficial to provide good investor rights and protections at the point of entry, if the capital can flow, thereafter, into a separate entity that in turn provides limited rights or protections to underlying investors. Most sophisticated investors will scrutinise the entire legal structure prior to investment and investment managers are advised to provide access to the organisational documents of each entity that might receive investor capital directly or indirectly. These documents should be provided on request to the investor and/or their legal advisor.

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## Investor Expectations and Preferences

- Investor shares provide relevant voting rights to fund investors.
- Service providers periodically report directly to the board.
- Information prepared by service providers delivered directly by them to the board.
- The board is ultimately responsible for valuation.
- The board is empowered to monitor and replace the fund's service providers, including the investment manager.
- The investment strategy is accurately described in the hedge fund's OM and there are relevant investment restrictions.
- The OM contains clear, reasonable and specific risk parameters.
- Investment terms are fair and reasonable and ensure investors' sufficient protection and the avoidance of conflicts of interest.

### 1.3 Board of Directors

#### 1.3.1 Content

Investors tend to favour investments in hedge funds that have a predominantly independent board of directors who are materially free of conflicts with the investment manager, and that boasts a variety of directly relevant skills and experience applicable to the investment strategy pursued by the fund.

#### 1.3.2 Requirements

Responsibility for the governance of a hedge fund rests with its board of directors. Although the board may delegate the investment management and administration of the fund, it remains ultimately responsible for the management of the company (the fund itself, to which the investment manager serves as an advisor) and has a fiduciary duty to the fund and its shareholders as a whole. Therefore, investors believe it is imperative that the hedge fund's board of directors consist predominantly of independent, competent and knowledgeable individuals.

Investors expect that an "independent" director should be free from all conflicts with the fund, its service providers, the investment manager and any of their respective directors, partners, principals, officers or employees. It is important to stress that an "independent" director of a hedge fund is compensated by the fund, and not by the investment manager. Further, a director's remuneration should be commensurate with the level of responsibility that the director demonstrates in overseeing the operations of the fund.

The hedge fund director's primary duty is to protect the interests of the investors. This duty is exercised by providing oversight of the hedge fund's operations, oversight of its service providers (including those of the hedge fund's investment manager or advisor), ensuring adherence to the investment strategy, and by reviewing marketing material and investor reports to ensure that these provide adequate and accurate information to existing and prospective investors.

Concerns surrounding a person's ability to undertake a directorship effectively, particularly during challenging times, can arise when individuals hold a large number of board directorships. It is therefore good practice to ascertain the number of board directorships that a prospective director holds, before they are appointed, in order to ensure that the

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capacity exists for them to get involved, actively, in resolving issues. One regulator, who is documented as expressing concerns regarding the high number of directorships held by some individuals, now requires that director applications from individuals who hold more than 30 directorships make certain disclosures to the board of the relevant fund/firm proposing them as director.

A critical factor in the standard of hedge fund governance is the role, responsibility and quality of a fund's independent directors. They are frequently provided by offshore corporate services firms and proposed for appointment by the investment manager at the suggestion of either the fund's administrator or legal counsel. There is a wide spectrum of these firms, some providing useful and essential secretarial and administrative services but no more. For these, investors believe that it is imperative that the fund's directors do not recognise the investment manager as their "client", that they do not serve both as directors of the fund and of the investment manager, nor that they absolve themselves (either through the hedge fund's OM or service level agreement) of responsibility for valuation or other critical governance or oversight matters.

Despite the private nature of hedge fund investments, the trajectory of their governance is towards the public market model of strong, independent boards and democratically empowered investors. Investment managers are advised to look to public markets for guidance on governance best practice, as the institutionalisation of the hedge fund industry should inevitably push fund governance in the direction of public market best practice.

### Investor Expectations and Preferences

- The board is constituted of no less than three and no more than five directors.
- The board consists of a majority of independent directors.
- Quorum for making key decisions includes at least one independent director.
- One of the independent directors serves as chairman and casts a deciding vote, as necessary.
- The directors have professional experience relevant to the activities of the fund.
- The breadth of board experience should be balanced among the various functional areas in the hedge fund marketplace.
- The directors serve on a modest number of boards, commensurate with the reasonable expectation that they have the time to deal with and properly resolve complex or extraordinary issues.
- Board meetings are held at least quarterly, one of which must be held in person by the directors.
- Adequate directors' and officers' liability insurance is in place covering the fund's directors.

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As authored by Andrea Gentilini, Union Bancaire Privée (UBP).

## 2 RISK

### 2.1 Reporting

#### 2.1.1 Content

Hedge fund risk reporting should provide an investor with the necessary tools to understand how much risk a manager is utilising within their portfolio. It is essential that these reports are comprehensive, consistent and regular in their transmission. Investors expect that hedge fund risk reports should include details of the risk metrics and other analyses that have gone into preparing the information.

#### 2.1.2 Requirements

Investors want to see replicable risk so that, given full position transparency, they are able to re-calculate all risk metrics and arrive at the same numbers as those that appear in the report. A scenario where hedge funds regularly open their books to investors who re-calculate all metrics at month end is hardly practical. Nonetheless, investors expect managers to provide enough transparency for investors to be able to arrive, in principle, at the same risk numbers that were provided for the entire portfolio.

For replication to be possible, financial risk metrics should be clearly defined. Using Value at Risk ("VaR" hereafter) as an example, hedge fund managers should specify exactly which VaR metric they are reporting (e.g., confidence interval and period), how it is calculated (e.g., historical simulation versus a model building approach) and whether in-house tools or third party software is utilised. The details of risk metrics can be outlined via an appendix that the hedge fund manager should make available to all of its investors. If a manager is using an external risk vendor then they should be able to aggregate and publish risk metrics, provided that the vendor is transparent in its methodologies.

Investors expect to receive risk information regarding hedge funds that is commensurate with the investment strategy or portfolio turnover. This does not mean that a fund that turns over its portfolio multiple times during a day should report risk that many times, or that a concentrated fund holding the same positions for more than a year should report only annually. In the case of a high-frequency trader, it is useful to show a distribution of portfolio risk snapshots taken at frequent intervals during a given trading day than merely publishing the VaR snapshot at month end. The investors in managers with long-term holdings may want to know about significant developments in the managing of each position on a frequent basis. Increasingly, hedge fund managers have started producing and circulating their risk reports on a monthly basis and this has partially been driven by investors' desire for more transparency.

The content and timeliness of reporting to investors should be consistent, so all investors should expect to receive the same information at the same time. Some investors may ask for more or the same information reported in a different manner. If a manager agrees to these *ad hoc* requests then they should consider if it is beneficial, reasonable or practical, to include any additional information into the standard risk report. When disseminating information to investors, managers should always be confident that they are treating their client base in a fair way.

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Investors expect that the risk metrics used to analyse a fund should be comprehensive. Risk metrics must allow investors to assess the risk of the hedge fund portfolio using their own methodology. In this respect, investors expect leverage analysis to be provided in both accounting and risk formats. The accounting analysis should contain both gross and net values for consistency of reporting, also the portion of gross leverage that is obtained by borrowing (explicit leverage) versus the one obtained by derivative instruments should be reported. Further, any definition of risk analysis should include VaR (including the methodology and underlying assumptions of the model, as mentioned above) for all strategies.

Investors like to receive risk reports that are reasonably and appropriately granular, providing a sufficient number of risk metrics to allow investors to fully understand what is being shown. A classic, and perhaps over-simplified, example of risk reports failing to be sufficiently granular are those that only report net leverage rather than both the gross and net figures. In fact, portfolios with very high gross leverage (hence risk) can be run underneath very modest net leverage. When, or if, correlations breakdown, netting rules change and it is at this point that the real risk may emerge and portfolio volatility increases. The presence of both gross and net leverage figures in a risk report might enable an investor to expect this risk, but it would be impossible to determine if only the net leverage was reported. If investors think that the key risk metrics used in reports do not mirror the nature and extent of changes in the portfolio, then they should expect additional or different risk metrics to be reported.

### Investor Expectations and Preferences

- Distribution of reports is frequent, usually on a monthly basis.
- Distribution is equitable so that all investors receive reports at the same time, where practical and reasonable.
- Hedge fund risk metrics are comprehensive. Leverage is reported in risk and accounting forms, the latter in gross and net forms, and VaR is reported.
- Risk reports are appropriately granular. The risk metrics and the changes to risk metrics being used in reports are a fair reflection of the evolution of the risks taken in the portfolio.

## 2.2 Portfolio Risk

### 2.2.1 Content

Portfolio risk analysis encompasses relevant and clearly applicable approaches to measure and control the overall risk of the portfolio. Both pre and post-allocation metrics are considered in this section. Position sizing and risk budgeting are illustrative elements of the pre-allocation portion, while position hedging and increased risk allocation to existing positions are standard elements of the post-allocation portion of portfolio risk management.

### 2.2.2 Requirements

In order to control and manage portfolio risk, investors expect hedge fund managers to define the key risks that are intrinsic in the strategy (or strategies) they pursue and for appropriate limits to be defined to manage these risks. Where hedge fund managers run fairly disparate strategies within an individual fund, investors expect the key risks to be

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identified and limits set at individual strategy level. Examples of some of these limits would be minimum diversification, maximum exposure to a certain sector, market capitalisation or investment strategy type.

Investors expect hedge fund managers to specify a maximum portfolio risk budget. While it is natural to expect managers to utilise the full risk budget during times when opportunities abound, investors expect managers to consider utilising less of the allotted maximum risk budget after a significant drawdown. Investors are very well aware of the fact that a position loss may eventually convert into a good opportunity and this is particularly true for some types of strategies, especially those that are value based. Nevertheless, investors expect some form of "stop-loss" in the broadest sense of the term, (i.e., control on accumulating losses in the spirit of prudent capital preservation).

Stop-losses are set so that a position is reduced or liquidated upon a certain loss trigger being reached. Stop-losses can be expressed in a variety of ways depending on the strategy. For momentum type strategies, stop-losses expressed in terms of price levels are common practice. Imposing cumulative stop-losses (expressed as maximum loss in basis points) over the position lifetime is a more generic approach which is suitable for numerous strategies. In setting a stop-loss, liquidation costs should be taken into account. Hedge fund managers that tend to increase their risk allocation to positions that are moving against them ("doubling down") should do so within the pre-defined limits of stop-losses.

Investors expect portfolio risks to be simulated under a variety of scenarios and, at the very minimum, managers should utilise the portfolio risk metrics discussed above to simulate the impact of new trade positions in the portfolio. It is preferable that risk simulations assess the portfolio's behaviour against a series of stress scenarios, including a variety of shocks. It is only by employing these tests that investors can gather, with some degree of confidence, an estimation of the strategy's robustness.

### Investor Expectations and Preferences

- Portfolio risk is controlled via appropriate metrics and corresponding limits.
- Overall portfolio risk should be assessed and where appropriate adjusted depending on the distance to the hedge fund's high-water mark.
- Losses should be curtailed depending on a pre-defined stop-loss budget.
- Portfolio risk should be simulated or stress tested before new positions are added.

## 2.3 Operational Risk

### 2.3.1 Content

When considering investment risk, in addition to the understanding, measuring and monitoring of portfolio risk, operational risk (risk not directly related to the investment process) should be assessed. In this section, the focus is on the assessment, measurement and mitigation of the sources of risk arising from the operational areas that will be discussed, later, in chapter 5, Operations.

### 2.3.2 Requirements

Hedge fund operational risk includes the identification of the operational areas that could potentially cause disruption to the investment process, which could lead to material losses for investors.

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Hedge fund investors should be able to identify the operational risks that are specific to the strategies that they employ. Investors should be made aware of these risks so that they can assess, for themselves, the risk that they are taking when they allocate their capital to a particular fund.

Once identified, operational risks should be documented and the rationale should be provided, outlining why specific operational risks apply to that manager. This explanatory document should be made available to investors during the course of their operational due diligence.

It is critical for investors that, where possible, operational risks are mitigated. Pre-emptive measures can be analysed, for example via a cost/benefit framework. A decision may be taken not to put in place a particular measure, perhaps due to the benefits being marginal versus the cost. Despite this, investors appreciate full transparency and will want to know the outcome of any analysis and the reasons why certain pre-emptive measures were, or were not, applied.

Investors have come to attribute high value to managers that have had all the identifiable operational risks quantified. There are several risk frameworks publicly available (e.g., the risk framework provided by Basel II). While none has gained unanimous acceptance, they all provide a starting point to quantify the potential impact of various operational risk scenarios. They can be used as a decision framework to prioritise one operational risk area versus another. For example, managers may consider quantifying the identified risk areas along a "probability of occurrence versus impact in case of occurrence dimension". The outcome of the two may serve as a basis to prioritise those areas on which to focus.

Investors consider it important that managers test their operational risk, including the mitigation framework. For example, in the event that a power loss is triggered in the network, a building evacuation is called without notice, or a fraud is simulated in the accounts, the ability of a hedge fund to show adequate countermeasures to such incidences goes a long way towards reinforcing the soundness of the firm's operational risk framework.

## Investor Expectations and Preferences

- Hedge fund operational risk areas must be identified.
- Hedge fund operational risk must be documented and be made available to investors during operational due diligence.
- Hedge fund operational risk areas should be mitigated by a set of countermeasures, where practicable.
- Hedge fund operational risk needs to be quantified.
- Operational risk frameworks must be tested including mitigation measures.

## 2.4 Counterparty Risk

### 2.4.1 Content

Hedge fund counterparty risk includes the quantification of the amount of client assets that are at risk due to cash, securities and other margins being deposited at counterparties that are subject to default risk. Please note the counterparty risk implied by the usage of service providers, such as information technology vendors and others, which do not have a trading relationship with the hedge fund manager are included in chapter 5, Operations, of this document.

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## 2.4.2 Requirements

Investors should expect hedge fund managers to ensure that all their counterparty risks are appropriately measured. Hedge fund managers should quantify the amount of investor assets that are at risk with each of their trading counterparties. In the context of this discussion, counterparties are to be understood as entities versus which the fund is at a risk of a loss (or a delay in the restitution of its assets) should such entity default. A prime broker is very often a counterparty since it holds custody of fund assets as collateral or has liens on those. Simple trading counterparties are often not counterparties in the sense considered here.

Hedge fund counterparty risks limits should be defined by the exposure of assets to each counterparty. The maximum share of investor assets (in absolute or percentage terms) that is exposed to the risk of default of a given counterparty must be calculated. The limits that are applied may vary, depending on the solvency risk of the selected counterparty, for example as measured by their CDS spread or other market variables.

As with other forms of risk, hedge fund counterparty risk should be diversified. Hedge fund managers should be able to demonstrate the ability to divert investor assets away from a counterparty that is at risk of default to another, in an expedited manner. Hedge fund managers with assets under management ("AUM" hereafter) in excess of USD 1 billion are advised to use more than one prime broker.

Investors may request that their counterparty risk is analysed from a legal perspective. This analysis should cover the default and likelihood of asset restitution based on the bankruptcy proceeding to which the defaulting counterparty would be subject (e.g., comparing the counterparty risk of a US based broker-dealer versus a UK based bank).

### Investor Expectations and Preferences

- Counterparty risk should be measured via an appropriate estimation of assets at risk.
- Counterparty risk should be capped with appropriate limits for each counterparty.
- Counterparty risk should be diversified and rapidly adjustable among counterparties.
- Counterparty risk should be legally analysed to prepare for asset restitution.

## 2.5 Liquidity risk

### 2.5.1 Content

Hedge fund liquidity risk includes the quantification of the liquidity on offer within the portfolio, the quantification of the market impact of fund divestments under different time horizons, as well as a critical understanding of the terms of portfolio liquidity versus investor liquidity.

### 2.5.2 Requirements

Investors believe that hedge fund managers should measure and actively monitor liquidity risk. Further, they should report the liquidity of their investment portfolios, to investors, by specifying which portion of the portfolio belongs to a particular liquidity category, and establish liquidity limits for their investments. Liquidity categories should be defined via measurable and verifiable metrics that include the ratio of position size to an average



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trading volume over a pre-defined period of time (e.g., which percentage of the portfolio is made up by positions whose size is <0.1%, <1%, <5%, >5% of the average daily trading volume).

The potential impact of liquidity risk should be regularly evaluated. The hedge fund managers may consider estimating the market impact (or cost) of divesting the portfolio within specific time periods and market conditions.

Investors certainly expect the liquidity profile of the portfolio to be aligned with the fund's redemption terms. Hedge fund managers may want to demonstrate quantitatively that the liquidity of their hedge fund portfolio permits them to fund a material percentage of investor redemptions under various market conditions and assumptions, without compromising the integrity of the portfolio. For example, a hedge fund manager offering investors monthly liquidity without gates and 15 days' notice should be managing a portfolio that can be divested within 15 days or less, without significant market impact.

Hedge fund managers may also consider having their fund liquidity simulated and stress tested. They should simulate the redemption volumes that investors may request under different performance scenarios (e.g., how many investors would redeem under a three months minus 10% drawdown scenario). This analysis should inform risk taking. That is, hedge fund managers may need to reduce risk significantly should the fund be exposed to a potentially significant redemption volume.

### Investor Expectations and Preferences

- Liquidity risk should be actively monitored to assess aggregate portfolio liquidity.
- The market impact or cost of liquidation should be quantified.
- Portfolio liquidity risk should be aligned with investor terms.
- Liquidity risk should be stress tested, including impact of increased margins/haircuts.

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## 3 INVESTMENTS

### 3.1 Performance

#### 3.1.1 Content

"Past performance is not necessarily indicative of future performance", is probably the most often referenced phrase regarding an obligatory disclaimer in finance. Nevertheless, fund performance is one of the primary factors used by investors to determine whether to conduct due diligence on a prospective hedge fund, allocate additional capital, or terminate an existing hedge fund investment.

In assessing a hedge fund's performance, a number of questions should be addressed by the hedge fund manager to assist the investor in determining whether the performance shown reflects the hedge fund manager's capabilities.

The primary objectives of the investors are to:

1. Determine whether the hedge fund manager(s) have a sustainable competitive advantage or unique skill-set.
2. Assess the probability that the hedge fund can meet investors' performance objectives.

#### 3.1.2 Requirements

Investors expect that all relevant hedge fund performance reports (both quantitative and qualitative) should be frequent (i.e., must be updated frequently enough for an investor to track the performance of the fund on a regular basis). This should be no less than monthly.

Investors expect that the distribution of the performance report should be equitable. All investors should receive the same information at the same time. However, this should not prevent an investor from requesting more information from a hedge fund manager that can be used in its own portfolio analytical system to assist it in better understanding the portfolio. Equitable treatment of investors does not mean that they should be treated exactly the same in every case, as each investor may have particular requirements that are reasonable and cannot be justified commercially for all investors in the fund. Additionally, some investors may be of strategic importance to the hedge fund manager and thus warrant special commercial consideration.

The performance report should be sufficiently detailed (i.e. comprised of comprehensive information to provide the investor with insight into how the performance was generated) (see chapter 2 Risk, section 2.1 Reporting).

This includes but is not limited to the items listed below.

1. How much hedge fund capital was being managed during the performance period?
2. How much of the hedge fund performance is based on realised results relative to unrealised gains, with special detail on the amount based on the valuation of illiquid assets?
3. What type of fund risk (volatility, leverage, level of portfolio concentration, etc.) was incurred to produce the performance (see chapter 2 Risk, section 2.1 Reporting, for more detail)?

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4. What was the attribution of performance among the various investment strategies (if a multi-strategy) of the fund for both its long and short portfolios?

Investors like to see that any hedge fund report should be both comprehensive and consistent. The report should provide historical information such as past performance, sector allocations, geographic exposure, hedge fund AUM, hedge fund leverage, hedge fund liquidity provisions, counterparty risk, etc. Investors expect to see changes made in the portfolio over time. This provides the investor with a deeper understanding of the portfolio and improves its ability to assess the hedge fund managers' skill-sets.

Investors strongly recommended that the hedge fund report distinguishes between audited, non-audited and *pro-forma* fund performance. A comprehensive report should allow the hedge fund investor to follow the performance of the fund relative to a variety of other factors. This should provide the investor with insight into whether the manager has a discernable skill and/or a sustainable competitive advantage.

### Investor Expectations and Preferences

- Distribution of hedge fund reporting is frequent and no less than monthly.
- Equitable distribution of hedge fund reporting with all investors receiving reports at the same time, where reasonable and practical.
- All hedge fund performance reports provide sufficient detail with various hedge fund performance factors being included in the report.
- The hedge fund performance report should be comprehensive and consistent, providing a level of historical information that offers the investor a view into the portfolio during different time periods that provides insight into how the fund was positioned. This should enable an investor to determine if the fund has a high probability of meeting the investor's expectations.
- A detailed investor communication is included with the hedge fund performance report that provides granularity around the investment decisions that worked and did not work, as well as how the portfolio is currently structured and the rationale for the current positioning.
- The hedge fund report offers an outlook for its investment strategy and identifies some catalysts and the potential timings associated with them.
- Valuable insight into the broader investment landscape should be included within the hedge fund report.

## 3.2 Terms

### 3.2.1 Content

Terms and conditions pertaining to the hedge fund manager are expected to reflect an "alignment of interests" between the hedge fund manager and its investor. An alignment of interests covers many aspects of this partnership. Investors classify these into three "pillars" - economics, control of assets, and transparency.

### 3.2.2 Requirements

#### 3.2.2.1 Economics

**Management fee structures:** Investors expect that the hedge fund manager's fee structure (both its management fees and its performance fees) should take into consideration the hedge fund's strategy, the size of an investor's allocation to the hedge fund, and the size of both the fund and the firm. Management fees should be

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designed to sustain the hedge fund manager's business without encouraging asset gathering. Fund incentive fees should: (i) have a hurdle rate no less than the yield on a cash investment that matches the duration of the fund's lock-up, and (ii) should only be fully realised when the investor has the ability to redeem from the fund. Investors will take into consideration all the above when determining whether the fund is providing an alignment of interests that fosters a long-term relationship.

**Crystallisation of performance fees:** Arrangements, which call for annual (or less) crystallisation of performance fees, do not adequately reflect the incentives associated with a long-term relationship. These types of arrangements are particularly troublesome to the investor when the hedge fund manager has realised a large performance fee only to suffer a sizable loss over the next performance period, thus resulting in a minimal capital gain or even a net capital loss for its investor over the combined period. However, the hedge fund manager, still, has made a profit over the same period.

Investors typically seek to align the manager's interest with their own. One aspect of this alignment, related to performance fees, has been the increasing use of such fees being paid over several periods, such that all accrued performance fees do not crystallise in year earned. An approach increasingly favoured by investors is to allow partial crystallisations of hedge fund performance fees, as appropriate and dependent upon the relevant fund's strategy, liquidity expected or targeted performance time horizon for the fund/strategy, and the fund's risk parameters. For example a performance fee arrangement of this nature may allow the hedge fund manager to crystallise a proportion of their performance fee in the first year, and attribute the remaining amount pro rata over several periods (e.g. 50% now, and 25% in each of the next two years). This approach will result in a portion of the un-crystallised performance fees being held in accrual and subject to fund claw back.

It is also important to investors that their hedge fund managers (including the senior team) have a substantial investment in the funds. This alignment of interests can be accomplished in a variety of ways. The preferred way is for the hedge fund manager to be a co-investor in the fund and held to the same liquidity terms as that of its investors. It is important that a significant amount of a hedge fund managers (and senior team) wealth is invested in the fund(s) that the firm manages. If the investor does not feel that the hedge fund manager has enough of its own capital invested in the fund, the hedge fund manager should be expected to reinvest a portion of the performance fees in the hedge fund.

**Business management:** A hedge fund manager should be able to explain and demonstrate how it will retain its firm's talent in the event of a difficult period of underperformance. Investors assume that hedge fund managers consider this factor when assessing companies to include in their own portfolios. Anything less adds to an unquantifiable and unacceptable level of risk to an investment in a hedge fund manager.

When appraising the hedge fund manager's business model, its investors should expect the hedge fund manager to discuss and provide the following:

1. Evidence that the firm's management and fund performance fee structures (including fund hurdle rates or the lack thereof) are appropriate given the fund's investment strategy, investment universe, time horizon and operating structure.
2. A common-sense proposal for ensuring that crystallisation of fund performance fees strikes a proper balance between short-term and long-term goals for both the hedge fund investor and hedge fund manager alike.

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3. A sound rationale for the liquidity terms stipulated in the terms and how it ties into the investment approach.
4. The percentage of the hedge fund's AUM that belongs to the manager and its key decision makers.
5. A process for quickly disseminating important and relevant information with investors with regards to material information that can impact an investor's decision to remain in the hedge fund. For example, a change at the senior level of decision makers or any change in manager ownership.
6. A business plan that illustrates the firm can operate with its current resources (systems and people) for a period of at least one year solely on its management fee.

### 3.2.2.2 Control of Assets

The vast majority of hedge fund investors invest in hedge funds through commingled funds, even though each investor's risk and return expectations and liquidity profiles are different. Consequently, investors who might otherwise be willing to endure what may be temporary price dislocations, often feel forced to redeem from the fund in order to avoid being last in the queue.

A number of methods are available to allow hedge fund investors to have better control over its assets within the hedge fund. However, the options are usually dictated by the size of the allocations made by the investor. The larger allocators set up separate or managed accounts with the hedge fund, whereas the smaller allocators invest in the hedge fund's commingled fund.

Independent of the size of the hedge fund investor, the relevant fund documents should be explicit as to the percentage of capital the investor will receive within one year and the duration of time it will take before all capital is returned to the investor.

Language needs to be specific as to why gates are imposed and for what duration of time they will be in place. Withholding capital for longer than one year needs to be explained. More importantly investors expect to be provided with a specific time frame as to when it will receive its capital in full without further constraints.

Regardless of the vehicle in which the investor uses to gain access to the hedge fund, far too often the hedge fund's operational documents provide the hedge fund manager with too much flexibility (see chapter 1. Governance, section 1.1 Relevance) in the form of lock-up periods, ability to gate or suspend fund redemptions change in manager control, among other things. In other instances, the hedge fund's documents are too narrow or vague. For instance, some fund liquidity terms offer a potential mismatch between the duration of the investments and fund liquidity, or do not allow for a fund gate when one is appropriate. Hedge fund investors are increasingly seeking to minimise these risks by structuring relationships so that they are properly tailored to the specific fund manager's investment strategy with that of the fund's general type of investors. If structured properly, the hedge fund should provide an investor with sufficient flexibility to render its own determination of the continued viability of the investment vehicle on an ongoing basis. However, it is important that a hedge fund's investors do not have the ability to compromise the hedge fund manager's business or other clients' capital by having too much latitude in forcing liquidity. Hedge fund managers should not be placed in a situation, which has occurred in the past, when they feel compelled to focus on raising cash for the next redemption period rather than maximising risk-adjusted returns.

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### 3.2.2.3 Transparency

Another key element of a strong and desirable alignment of interests is the transparency of a hedge fund's investments and risks. Ideally, a hedge fund investor is expected to be able to access the level of information it deems appropriate to adequately evaluate and understand portfolio risks (see chapter 2 Risk). Transparency is often one of the more contentious issues within the industry. Investors feel that they require more transparency since it is their capital being invested, while hedge fund managers prefer to provide less, based on the view that this could lead to an uncontrolled dissemination of their intellectual property, which could disadvantage the hedge fund and its investors. Both points are valid and before making an investment, the investor should agree with the hedge fund manager on the level of ongoing transparency that they should expect to see. Inevitably, the resistance of hedge fund managers to offer appropriate transparency levels to potential investors will lead to the prevention of asset growth in their strategy.

#### Investor Expectations and Preferences

- Management fees should be designed to cover operating costs.
- Performance fees should be structured in a manner consistent with the underlying strategy, investment horizon and liquidity including, where appropriate, the crystallisation of some portion of the fee over several periods.
- Business model should be designed to retain majority of investment and management talent when the fund is below the high-water mark for more than a year.
- Control of assets so that the investor has the ability to receive most, if not all, of its capital within a year or less with minimal, if any, constraints.
- Transparency that is sufficient for the client to understand the hedge fund exposures and the risks taken in the portfolio, as well as performance drivers.
- Transparency so that the investor receives security level information that can be used in a risk analytics tool.

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## 4 CAPITAL

### 4.1 Firm Ownership

#### 4.1.1 Content

This section deals with the types of information hedge fund investors could expect to have in order to better understand a hedge fund manager's capital structure. Potential hedge fund investors should understand how the firm's capital structure and the sources of capital impact upon the decision making and behaviour of the principals of the firm. Here we use capital as a definition to describe the economic capital a firm requires to successfully execute their business strategy and assumes any regulatory capital requirements in a particular jurisdiction are fulfilled as a minimum. These factors should be considered in conjunction with the firm's risk appetite, including leverage, its performance, and its aspirations for the growth of the business. Further, these factors will assist a potential fund investor in their understanding of the firm's stability during periods of stress from either external factors (e.g., market conditions) or internally driven issue, (e.g., specific fund performance).

A variety of ownership models exist and a hedge fund firm's ownership structure should be fully transparent to investors. Further, where possible, this should be aligned with the hedge fund firm's investment strategy. A fund focused on highly illiquid and difficult-to-value assets may need a different resource and capital requirement to one which specialises in liquid, transparent investments.

A hedge fund investor should be able to analyse the relevant aspirations of the fund; namely the capacity of a particular investment strategy and the availability of capital and resources to achieve that goal. The hedge fund capital structure should ideally exhibit stability when under conditions of market stress. The hedge fund manager should not be reliant on its performance fees to operate its fund (see chapter 3 Investments, section 3.2.2.1 Economics). Whether capital is sourced externally, through a public listing or a private equity investment, or internally, succession plans and/or manager exit strategies should be defined to the governing board and shared with fund investors where appropriate.

#### 4.1.2 Requirements

There are a range of business models that are widely acceptable to institutional investors in hedge funds. Among the most important factors requested of a hedge fund manager from an investor are details regarding the stability of the firm's capital structure, particularly how it is expected to evolve as the investment strategy and the hedge fund matures.

Potential hedge fund investors want to be able to see an overview of the investment manager's capital base, whether resourced through internally or externally sourced capital, to be able to establish whether the articulated investment strategy can be supported by the available capital and that any growth can be adequately resourced and controlled. For example, a fund that has an aspiration to add other strategies may require additional capital to its fund operations as it becomes more complex.

A firm that is primarily owned by its employees is likely to enjoy a healthy alignment with its investors. Such an alignment requires the ownership stake to be material (see chapter 3 Investments, section 3.2.2.1 Economics). The firm should have restrictions on employees removing capital from their stakes in the firm. These should be established in such a way to ensure that the employee is motivated to remain employed by the hedge fund manager

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for a sufficient time, defined by the investment strategy being employed. This can be anywhere from 1 to 3 years, or longer. This ensures that consistently high performers are rewarded and encouraged to remain with the firm.

It is important that a balance is struck between reward for a few key decision-makers of the firm and a wider group of employees. The investment manager's growth plans and/or its succession strategies should provide a steer to its culture and development aspirations. Some questions to ask would be:

1. Are employee holdings concentrated among a few, or is there a spread among a larger number of employees?
2. Does the structure of the firm's capital fit with the defined investment strategy and does this align with future business plans? Are there existing or planned caps/limits on funds/strategies which have implications for growth?
3. Is the capital base structured to allow changes and are these appropriate to the investment strategy and its time horizon?

These plans should be shared with investors who are likely to have their own views on the potential capacity for a particular hedge fund strategy and the appropriate size of resources required to successfully achieve that plan. If leverage is used by the hedge fund, the terms and covenants need to be understood, as it could impact the returns and may be destabilising to the investment strategy of the fund.

Where investment capital is sourced externally, (e.g., from a private equity investor or via a public listing, such as an IPO), a balance needs to be struck between returns on capital to employees and returns to external providers of capital, which are able to adapt and be consistent with the firm's growth plans. This will assist the culture and stability of the firm and help to generate better returns in the long run for the investors. The objective and motives behind this source of investment capital should be fully understood. Highlighting asset growth targets and fund exit strategies should allow potential investors to understand where conflicts and misalignment within the firm may arise. In addition, fund investors need to understand the implications of any regulatory requirements with respect to the publication of information on the fund strategy and the hedge fund manager.

It is important to ensure that talented investment managers are retained and remain motivated. Risk managers should be remunerated independently of fund performance and adequately for the complexity of the fund.

In conclusion, the stability of the investment manager's capital, at all times, needs to be understood.

### Investor Expectations and Preferences

- Ownership aligned with strategy ensures stability. Capital is not too intensively held in too few hands. Key personnel rewarded and participating in the firm's success.
- Model allows adequate growth for employee retention and business evolution.
- Risk adjusted return generation is encouraged over asset gathering.
- Providers of capital clearly understand objectives.
- Stability of capital is suitable for the investment style being pursued.
- Capital structure is clearly defined and sets explicit capacity targets/caps on growth.
- Exit strategies, where relevant, are defined.
- Culture is aligned with capital structure.



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## 4.2 Fund Investors

### 4.2.1 Content

Potential hedge fund investors increasingly assess the diversity of the fund's existing investors to ensure an appropriate balance is in place to support fund stability. All investors of the firm should be treated equitably. As already stated (in chapter 3 Investments, section 3.1.2 Requirements), this does not mean that all investors should be treated exactly the same in every case, as each investor may have particular requirements that are reasonable and cannot be justified commercially for all investors in the fund. Additionally, some investors may be of strategic importance to the hedge fund manager and thus warrant special commercial consideration.

### 4.2.2 Requirements

The ongoing stability of the fund and its target capacity are key elements which enable the firm's investment managers to optimise its investment performance, especially during times of stress. Access to the other hedge fund investors, where prior permission has been granted, during the due diligence process will assist investors in understanding any potential organisational issues of the fund during times of stress. References taken directly from other investors are also helpful. Further, it would be useful to analyse the firm's investor base by the length of time it has invested in the fund, as well as by investor type and by the relevant fund domicile.

The history of the fund, and in particular the experience of investor behaviour during times of stress, is relevant for considering the potential impact on future fund returns. This should allow an appropriate assessment to be made regarding the potential for any destabilising actions which may impact the fund, such as different liquidity terms. For example, where a fund has had to invoke gate clauses, or alter its investment strategy due to market stress, it is helpful for fund investors to be able to access how the investor base behaved. The existence of most favoured nation ("MFN" hereafter) clauses, side letters, co-investments or special arrangements need to be disclosed to investors and updates should be provided to them regularly. Equitable treatment of investors promotes their confidence.

#### Investor Expectations and Preferences

- Hedge fund client base ideally well diversified by geography, objectives and/or balance sheet composition.
- Awareness of other fund investors.
- Equitable treatment with MFN clauses and side letters covering reasonable legal points and applied reasonably.
- Evidence of an institutional client base.
- Ideally, a potential investor should have access to other investors in the fund and be able to take up references from them.

## 4.3 Investor Relations

### 4.3.1 Content

The investor relations team of a hedge fund firm is expected to be both adequately resourced and appropriately informed to enable them to publish a regular, consistent set of fund documents and reports which can be easily interpreted by their investors.

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## 4.3.2 Requirements

Investors expect hedge fund investor relations teams to be sufficiently resourced to produce a regular set of reports for investors. Reports should be comprehensive, timely and distributed to all investors. The content of these reports should include key risk metrics around hedge fund performance, hedge fund exposures and risks by sector, portfolio sensitivity to market stresses and shocks, VAR, indicators of hedge fund leverage and hedge fund AUM. In addition, these reports should be supported by relevant analysis with performance attribution, explaining the reasons behind fund performance and any key changes that are made to the fund including, but not limited to, changes in investment personnel, service providers or changes to the fund's governance arrangements (see also, chapter 2 Risk, section 2.1 Reporting and chapter 3 Investments, section 3.1.2 Requirements). Where possible, the use of external consultants to provide independent reporting and risk reports adds to investor confidence.

Hedge fund investor relations teams should be responsive to investor queries, in terms of both the content and timeliness of the response. The team should possess expertise to communicate key information to investors. Furthermore, they should demonstrate a clear understanding of the fund investment process including, among other skills, an ability to describe trade selection, implementation and portfolio construction, as well as to explain the economic rationale for the hedge fund strategy/strategies employed. It is helpful to provide examples explaining the rationale and the outcome of positions taken by the fund.

Sophisticated investor relations professionals should be sensitive to the needs of the funds' investors so they can ideally seek to pre-empt relevant enquiries. The investor relations team must treat all its fund investors fairly.

Investor Expectations and Preferences
<ul style="list-style-type: none"><li>• Adequate resources to regularly publish risk reports and investor correspondence with at least monthly frequency. Ideally, the regularly published risk report could be submitted by an independent consultant.</li><li>• Investor reports clearly explain performance attribution. Selective position-level transparency is helpful.</li><li>• Investor letter discusses/details rationale and outcome of positions and clearly explains performance drivers, and indicates expected positioning for the future and rationale.</li><li>• Hedge fund risk reports provide a portfolio exposure break-down by sector and geography, VaR, leverage and AUM.</li><li>• Investor relations team responds in a timely manner (within 3 days) to investor requests. The team possesses expertise and qualifications to discuss the fund's investment process, in detail.</li><li>• The investor relations team understands issues from the investor's perspective and is able to pre-empt queries with clearly written communications.</li></ul>

## 4.4 Sales and Marketing

### 4.4.1 Content

The hedge fund's sales and marketing team should describe to potential investors, what the hedge fund does, (including all its objectives), how the hedge fund principals work together, the firm's ownership structure, risk management and the governance process.

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### 4.4.2 Requirements

Hedge fund marketing materials should clearly outline the fund's investment objectives, its strategy, the investment manager's ownership structure and organisation, as well as outline other key elements and information that will enable investors to make their own assessment on the attractiveness of the hedge fund strategies. Investors will want to be able to model the fund in a way that will assess how it relates to their specific investment requirements. Potential hedge fund investors should be furnished with information which allows them to understand the key risks of the fund and have a clear description of its strategy/strategies and an appraisal of its performance (profits earned and losses incurred) to date.

Potential investors expect to have information which helps them to access the funds' competitive advantage and the repeatability of a successful hedge fund strategy. Among the cultural statements which demonstrate the aspirations of the leadership team of the firm, information should be included regarding its ownership structure, staff levels and manager incentive provisions. These should be made available upon request with any major clients and their tenure disclosed, subject to prior approval. The target capacity of the hedge fund and the investment manager's expectations regarding maximum capacity should be disclosed to all investors. Investor materials should be comprehensive and made available in a reasonably short timeframe to allow the investors to conduct timely due diligence and relevant reviews on the fund principals' backgrounds.

#### Investor Expectations and Preferences

- Hedge fund investment objectives and strategy are clearly defined.
- Ownership structure explained and easily understandable.
- History of firm/individuals made available with clear disclosure on each.
- Strong cultural statements to offer potential investors an understanding of the firm's aspirations.
- The marketing team responds within a reasonable timeframe.
- Due diligence documents are comprehensive and made available in a reasonable timeframe.
- References made available upon request.
- Investor requirements anticipated and documentation is comprehensive.

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*As authored by Adrian Sales, Albourne.*

## 5 OPERATIONS

### 5.1 Organisation and Control Environment

#### 5.1.1 Content

The implementation of best practices starts with the structure of the organisation and requires constant evaluation. There are a number of factors that influence how the manager is structured, including size and location, but certain fundamentals apply regardless.

#### 5.1.2 Requirements

##### 5.1.2.1 Corporate Structure

The firm should have a clear corporate organisation chart that shows parents, subsidiaries and other affiliated entities. The firm should have appropriate legal agreements in place and take certain other factors into consideration, including key-person risk, equity distribution to key staff, a sustainable capital base, and tax considerations at both firm and fund level. Investors expect to obtain a clear understanding of the management firm, its history, ownership structure, office locations, its activities and the activities of affiliates. Hedge funds often have affiliations with other financial services firms (e.g., they may utilise an operating platform, share offices or have seeding relationships) and investors will expect an explanation of these relationships, and related controls.

##### 5.1.2.2 Oversight and Reporting Lines

The firm should be structured to allow for adequate oversight of the primary functions within the firm. Investors want to see a clear organisation chart showing, at a minimum, reporting lines, team numbers, and the names of key professionals in order to understand how the team is organised by function. There should be suitable oversight mechanisms, the extent of which will depend largely on strategy, which could be external (such as parent company audits, Sarbanes-Oxley, SAS70/ISAE 3402 and for the fund-independent directors) but also ideally internal (such as committees providing oversight to valuation, risk, compliance, etc.).

##### 5.1.2.3 Separation of Duties

The organisation should demonstrate clear segregation of duties and levels of staffing given the complexity of strategy and risks. Even in a small firm, with an appropriate structure the manager will be able to implement adequate duty separation. Firstly, there should be clearly defined roles differentiating, at a minimum, the front office, back office and compliance functions. Secondly, functions should be properly separated within the back office.

While there are several potential areas of concern, duty separation should at least allow for:

1. Proper authority levels on cash and asset movements, reconciliations and confirmations, preferably with no involvement from the front office.

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2. Limitation of front office authority in valuations. While the front office often is, and should be, involved in pricing, internally final authority should reside with the back office.
3. Strict separation of duties where staff are related to one another to avoid any potential collusion.

### 5.1.2.4 Staff

Employees should have appropriate experience and education, and staffing levels should be sufficient to support the strategy and to provide coverage during absence. Where consultants are used in the business, their role and influence should be clarified. The firm should re-evaluate resources as it grows or changes. Managers should explain where employees are located, how personnel in different locations interact and how their knowledge base is kept up to date.

### 5.1.2.5 Retention and Turnover

Investors will want to gain an understanding of what compensation schemes are in place, the vesting period of bonus schemes, and whether compensation for control functions is linked to fund performance, as well as the alignment of interests with investors. Turnover is a reality, and often healthy, but should be manageable. Investors will expect to be notified of key hires and departures as well as want to understand the reasons behind recent turnover.

### 5.1.2.6 Service Providers

The manager should select appropriate service providers for the strategy, including legal counsel, auditors, prime brokers and administrators. Any changes in service providers should represent an upgrade and be reported to investors.

### 5.1.2.7 Influence and Authority

The back office should have a strong voice in the firm, with a high level of authority and influence in the organisation. There should be a senior chief operating officer ("COO" hereafter)/chief financial officer ("CFO" hereafter) independent of the investment process, with authority over operational processes. The more complex and larger the business, the more likely such a role would need to be divided (into a CFO and COO). For example, investors will look for representation on management committees, consideration on counterparty selection, authority over the pricing process and involvement in determining long-term strategic decisions.

### 5.1.2.8 Documentation

Internal organisational procedures, controls and systems should be documented, with the extent of the documentation dependent on the complexity of the hedge fund manager's business operations. Documentation should be up to date and made available to investors.

### 5.1.2.9 Conflicts

Investors will want to see a documented conflicts policy, together with an understanding of what steps have been taken to identify and resolve conflicts, and the existence of a conflicts or compliance committee to manage conflicts and develop a framework for disclosure of conflicts. Investors are likely to have a broad definition of what might constitute a conflict, and will make enquiries as to the relationships in the fund board, family relations or connections at the firm, external affiliations of staff, shared office space, affiliated businesses, such as broker dealers, as well as equitable allocation practices between funds. Where managed accounts and other vehicles are

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handled in a similar manner to the commingled fund, investors will want to understand the terms and fees of these vehicles. Undisclosed conflicts can call into question a manager's integrity.

## 5.1.2.10 Disclosure

While managers will produce standard documentation that complies with legal and regulatory obligations, investors will expect substantially more disclosure in the form of due diligence questionnaires ("DDQ"s hereafter), historic reports and sample documentation such as operations manuals, valuation policies and samples of board meeting minutes (redacted if necessary). Investors will want an understanding of what other funds are managed by the firm/manager together with the history of the firm's investment management products (such as whether they are open or closed, above high-water mark, whether there have been any funds that have liquidated, gated, restructured and the circumstances that underlie these events). Where management represents a substantive investment in the fund (e.g., as an alignment of interest), investors will want evidence of this investment. Investors generally want their "expectations managed", and managers should promote a culture of openness and operate a process for disclosure of events or actions prior to them occurring, or promptly thereafter.

Investor Expectations and Preferences
<ul style="list-style-type: none"><li>• Clear corporate organisation chart that shows parents, subsidiaries and other affiliated entities.</li><li>• Hedge fund firm's front and back office systems are segregated by personnel and system access is restricted.</li><li>• Internal organisations procedures, controls and systems should be documented; these should be up to date and made available to investors.</li><li>• Documented conflicts policy (together with an understanding of what steps may have been taken to identify and resolve those conflicts) to be provided to investors.</li><li>• Extensive disclosure for the investor via DDQs (e.g., AIMA DDQ), historic reports.</li></ul>

## 5.2 Compliance

### 5.2.1 Content

Investors expect to see a strong compliance culture at a firm starting at the top and a robust compliance program should include procedures, training and surveillance. For smaller often closely held businesses, such as hedge funds, strong legal and compliance controls are paramount and increasingly will be a focus of attention from investors, who will want to be assured that potential problems can be arrested early on. Best practices should always exceed minimum disclosure.

### 5.2.2 Requirements

#### 5.2.2.1 Legal and Regulatory Issues

Investors expect full disclosure of any legal or regulatory issues (past, present and pending) concerning the firm, funds or key individuals (including directors). Many investors are likely to hire a third party firm to carry out an investigation, and will cross-check the manager's disclosures and representations with their own enquiries.

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Discrepancies can call into question a manager's integrity. If previous legal/regulatory issues have been encountered by a manager, proper disclosure and remedies should be implemented to address these issues.

### 5.2.2.2 Regulatory Registrations

Investors should expect a manager to understand the regulatory environment within which it operates and the specific rules applicable to its business. Investors will want to satisfy themselves that all required registrations are in place, and understand why the manager is not registered in jurisdictions where they are physically based. Where managers are preparing to become registered for the first time, a proper gap analysis and implementation plan should be in place. Investors will want to understand, in outline, the results of regulatory visits and may ask to see copies of key reports. Even if a firm is unregistered with a regulatory body, it still should operate to the same standards as if it was registered. The manager should be able to evidence control improvements put in place following any deficiencies raised by a regulatory inspection.

### 5.2.2.3 Resources

Investors will want to be assured that the manager has appropriate people, systems and controls to monitor risks and conflicts. Investors will want to be satisfied that the compliance function is independent of the investment function and appropriately resourced. Responsibility for the manager's compliance issues is generally overseen by the manager's chief compliance officer ("CCO" hereafter). Best practice is to have a dedicated legal/compliance function in-house although, as with other roles, the CCO role is sometimes shared, in many hedge funds, by the firm's general counsel, COO or CFO.

It is unusual in smaller managers for its compliance officer to be full time; however, investors will still expect that individual to have a sound knowledge of all rules and regulations pertaining to the firm's investment and non-investment activities. Where this is the case, the manager should have an arrangement with appropriate professionals, such as compliance consultants or legal counsel, for further advice and guidance. However, it is critical that where elements of the compliance function are outsourced, the overall responsibility still remains with the manager. Further, the manager should ensure that this individual has sufficient time to dedicate to the task and that recurring tasks, such as record keeping and compliance monitoring, are completed on a timely basis. The compliance officer should act with the necessary authority to enforce compliance with relevant rules and internal procedures.

### 5.2.2.4 Compliance Manual

Every manager should have a compliance manual which sets out extensive policies and controls to ensure that the hedge fund manager complies with both internal guidelines and external regulation. Investors will want to review the compliance manual that documents the procedures and controls and assure themselves that the manual is updated regularly as a "live document", is tailored to the business and that the policies in key areas are appropriate. When new policies are implemented, the manual should be updated accordingly with a copy given to every member of staff.

### 5.2.2.5 Policies

The CCO should monitor legal and market changes to best practices, updating the compliance manual and undertaking training as needed.

The issues are constantly evolving and while not a complete list, the following are current areas of focus by investors:

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1. Investors expect that the hedge fund manager adopts a personal account dealing policy that ensures that conflicts of interest between staff and its clients are effectively managed. The easiest way to avoid these conflicts is for a hedge fund manager to prohibit its personnel from trading on their own account in securities which they analyse or in which they invest for clients. Indeed, it is preferred for staff to invest in the client hedge funds; thereby aligning their interest with those of their investors. However, this may not be appropriate in all circumstances and, provided adequate controls exist, personal account dealing may be permitted, albeit there should be low volumes. A personal account trading policy should be strictly enforced and monitored with written policies and procedures, minimum holding periods, restricted lists, broker statement collections and pre-approvals for all trades (unless on exempt securities). Monitoring and analysis of all personal account dealings should be undertaken by a person who is suitably competent in order to ensure proper management of the potential conflicts that may exist.
2. Side Letters: While the best approach is not to have side letter terms that may disadvantage certain investors, if a firm does choose to provide preferential terms to selected investors (e.g., fees, liquidity, transparency), this information should always be approved by the board of directors and disclosed to all existing and potential investors of the fund.
3. Soft Dollar or Commission Sharing: A policy for soft dollar/commission sharing usage should be clearly documented. Proper monitoring from non-trading personnel is required, to ensure policies are adhered to. The level of soft dollar/commission sharing at a firm should be appropriate for its strategy.
4. Anti-Money Laundering ("AML" hereafter): Firms should provide an oversight on AML monitoring regardless whether this function is handled in-house or by a third party administrator. The manager should visit and perform sample checks of the administrator's know your client ("KYC" hereafter) and AML documentation. Basic AML training should also be part of compliance training for firm employees.
5. Procedures with regards to material non-public information ("MNPI" hereafter) should be a basic component of any compliance manual and should define MNPI and clarify the escalation process, should staff encounter MNPI. Where a manager uses expert networks, every relationship should be pre-cleared with the compliance department, who should perform due diligence either on the individuals or the firm (if using an aggregator). Staff that work with such consultants should receive special training and compliance should undertake extensive surveillance (e.g., looking for trading spikes, reviewing trade volume around news releases, email searches and recording of telephone calls).
6. There should be a clearly documented trade error policy and process for recording and resolution, and the compliance department should document changes made to avoid repetition of an error.
7. Where the manager manages multiple funds, there should be clear procedures and controls in place to provide fair and equitable allocation of investments across different accounts so that none is favoured. There should be written policies and overrides of the standard allocation process and exceptions to the standard allocation should be accompanied with a detailed memorandum by a senior member of the firm. If rebalancing is required, transactions should be done at "arm's length" (i.e., at the market) to prevent price manipulation. Formal procedures should be in place for authorising orders (i.e., investment committee approval) with system restrictions. Detailed record retention policies should be in place with respect to books and records, emails, trade confirms, etc.



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### 5.2.2.6 Training

Managers should keep up to date on all compliance changes, and staff should be frequently trained and updated on compliance policies. Employees should be required to sign that they have received and read the compliance manual, on commencement of employment. Many hedge funds also utilise the services of third party compliance consultants. These firms provide a variety of services including establishing a firm's initial compliance program, assisting with ongoing compliance training and conducting mock audits, often modelled after an actual regulator examination. Depending on the nature of the contract with the manager, these firms also provide hedge funds with ongoing advice and news of regulatory and legal changes that may require revision of their existing policies.

### 5.2.2.7 Monitoring

Compliance staff should develop a comprehensive regulatory calendar and assignment grid. Investors will expect hedge fund managers to implement arrangements for the regular monitoring of business risks and for adherence to all compliance requirements. The frequency and scope of monitoring should be determined by the size and complexity of the business and compliance work should be targeted on those areas of highest risk. Surveillance should be both pre-trade (e.g., regulatory limits, restricted lists) and post-trade (e.g., review for MNPI). Typically, a hedge fund manager would conduct a formal monitoring exercise on at least an annual basis, which may be split into monthly or quarterly elements. There should be annual declarations from employees to confirm they have read the compliance manual and have complied with its policies and procedures. Procedures should be periodically tested or audited. Investors should expect that the results of monitoring will be documented and communicated to management. These communications should highlight where weaknesses or incidents have been identified and promptly resolved, as well as processes to ensure that changes in regulation are assessed and properly implemented.

#### Investor Expectations and Preferences

- Full disclosure of any legal issues (past, present and pending) concerning the firm, funds or key individuals.
- Firm's compliance function to be independent of its investment function, and appropriately resourced.
- Annual declarations from employees to confirm they have read and complied with firm policies and procedures.
- Appropriate level of compliance oversight into issues such as personal account dealing, AML, KYC and employee gift reporting, as well as investment strategy issues.
- Written code of workplace ethics with adequate training.
- If preferential side letter terms to selected investors exist (e.g., fees, liquidity, transparency) those terms should be approved by fund board of directors and disclosed to all potential and existing investors of the fund.

## 5.3 Trade Processes

### 5.3.1 Content

This section describes firm/manager processes and controls that investors expect for a robust execution of a hedge fund investment strategy. A manager is expected to organise its internal affairs in a responsible manner, ensuring it has the appropriate systems,

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procedures, controls and resources designed to mitigate and manage all risks to which its business is subject to and to ensure the safe-keeping of client assets, as well as the effective execution of its investment strategy.

### 5.3.2 Requirements

#### 5.3.2.1 Systems

Managers should ensure that the infrastructure is appropriately tailored to the business, and they should assess the market, frequently, for new products or enhancements. The suite of portfolio systems should allow, where appropriate, for a high degree of automation and straight-through processing ("STP" hereafter) for reliable books and records. The manager's systems infrastructure and level of automation must be suitable to the requirements and scale of its hedge fund investment strategy and should provide scalability to the fund and the firm.

Sometimes, vendor software or systems do not perfectly suit a fund manager's specific needs in terms of fund analytics, portfolio management, trading, etc. As a result, the hedge fund manager may develop its own proprietary software (and sometimes entirely bespoke programming code and algorithms) both to satisfy their process requirements as well as to safeguard mission-critical intellectual property. Managers must ensure that for the in-house systems that the firm owns, the intellectual property is properly secure, there are robust systems support and documented user manuals. The documentation of processes is particularly important as often the maintenance of proprietary systems is dependent on one or a few individuals with knowledge of the code or the software and their absence at a critical moment could have significant, adverse consequences. Safeguards and controls (such as user access) should be embedded into the hedge fund manager's processes and systems to mitigate the adverse consequences of errors where manual intervention is necessary and to enforce duty segregation.

Managers are encouraged to implement STP whenever practical. STP enables the entire trade process for capital markets and payment transactions to be conducted electronically, without the need for re-keying or manual intervention. The goal is to minimise settlement risk for the execution of a trade and its settlement and for clearing to occur simultaneously. (See *AIMA's Guide to Sound Practices for European Hedge Fund Managers*.)<sup>1</sup>

Processes to ensure the security of fund data should limit access to sensitive applications or data to the appropriate personnel by password or biometric security. There should be a centralised location for all portfolio data, with an extensive security master file and real-time reporting through direct market feeds. Managers should have systems that maintain comprehensive trading data (i.e., corporate actions, realised/unrealised gains, commissions, etc.) and a complete general ledger with partnership accounting; updated for current accounting requirements. Systems should include audit trails and access restrictions controlled by back office/compliance. There should be extensive system support (internal and external), and a regular review of the systems infrastructure.

#### 5.3.2.2 Trade Cycle

It is important for managers to formalise their internal middle/back office policies and procedures as part of a strong culture of corporate governance and to mitigate key-person risk. Internal trade cycle policies should be documented in a procedure manual that clarifies roles and responsibilities. Implementing a series of internal checks and balances helps to establish and promote an institutional approach.

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<sup>1</sup> Guide to Sound Practices for European Hedge Fund Managers, AIMA , 2007

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Whilst some managers utilise shadow accounting or rely entirely on their administrator, best practices call for managers to maintain a complete set of books and records internally and prepare full NAVs, at least, monthly. If managers do not maintain a full set of internal books, then they should be able to demonstrate oversight of external books through formal procedures, review of key management reports, integration into the NAV process and frequent contact/meetings with the service provider. They should be able to prepare estimated or indicative NAVs more frequently. If there is an administrator preparing the official NAV, there should be an internal line-by-line review of the accounting and investor allocation package by senior back office personnel. The manager also should establish formal policies for the allocation of trades and non-trading income/expense items. There should be evidence of reasonableness checks of investor returns by senior non-investment professionals to verify the accuracy of the allocations.

### 5.3.2.3 Reconciliation

Timely reconciliation and resolution of reconciling items is an unglamorous but essential requirement to promptly identify duplicate, missing or incorrect transactions. Triangular reconciliation of cash and positions should occur ideally daily, or at least frequently, between the manager, administrator, and prime broker/OTC counterparty. This process should be automated through the use of proprietary or third party systems, where possible. Where manual reconciliation is required, specific staff members should be accountable for the completion of the task. The manager should create a daily electronic checklist within the portfolio management system to ensure all accounts have been fully reconciled. Managers should produce a daily unsettled trades report and an escalation process should be in place for trades that do not settle within expected timeframes. Reconciliations (ideally automated) should also occur between the front office and back office systems, daily. The entire reconciliation process should be overseen by senior operations personnel (i.e., controller or CFO). The staff responsible for cash reconciliation should not be responsible for signing off cash transfers. Where possible, matching and confirmation systems should be utilised to facilitate the settlement process. Employees with specific credit experience (i.e., bank debt and OTC experience) should be required to ensure that these instruments are accurately settled. Generally, managers and administrators that reconcile corporate actions, accruals, fees, and expenses, on a daily basis, are able to close out their month end process in an expedited manner.

### 5.3.2.4 Cash Controls/Management

Controls over the cash process are probably one of the most fundamental and important functions at every hedge fund, and should be both preventive (i.e., a good signers list) and detective (i.e., reconciliations). A documented cash transfer and cash management policy should be established; best practice being for the administrator to be involved in all non-DVP third party wire movements either as initiator or approver, or both. This policy should include the minimum of two authorised signatures/approvers for cash transfers (with a preference to have more than two authorised signers on the list) to keep business disruptions due to absence or travelling etc. at a minimum. Additional controls can include call-backs, multiple levels of authority and approval limits. The administrator/prime broker should be provided with an updated signatories list and pre-approved counterparties. An electronic platform is the preferred method of transfer as it provides for proper controls with a clear audit trail. For electronic transfers, there should be one person setting up the wire, and two additional approvers. The person setting up the wire should not count as an approver. For larger managers, or those with a high volume of cash transactions, it is appropriate to have a dedicated treasury function. Cash balances and margin requirements should be subject to daily reconciliation and monitoring, including 3-way reconciliation to the prime broker and administrator, automatic exceptions-based reconciliations and proper

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supervision and sign-off by senior personnel (e.g., CFO). There should be a segregation of duties between signer and reconciliation personnel.

There should also be effective cash segregation, and, where appropriate, excess cash should be swept from prime brokers/OTC counterparties to cash or custody/trust accounts at banks or other financial institutions. Cash holdings should be diversified if the amounts are material. There should be active monitoring on credit rating/credit worthiness of the vehicle that cash is invested in, and managers should have a firm understanding and oversight of underlying assets that cash is invested in.

Bank and brokerage accounts opened in the name of the hedge fund should be operable only by authorised back office personnel, with signed authorisation by senior investment and operating principals and counter-signed by two independent directors of the relevant hedge fund/master fund.

### 5.3.2.5 Controls Testing

It is prudent for the manager to periodically test the robustness of its control processes and security measures. Some larger managers submit these items to tests administered by an external or independent specialist consultant. In this regard, a SAS 70/ISAE 3402 audit report is an effective and efficient tool and may boost investor confidence in the governance and controls surrounding the calculation/monitoring of a fund NAV for hedge funds and their managers, as well as increase confidence around a hedge fund managers' operations controls and its infrastructure. If managers lead investors to place reliance on such a report (e.g., by referencing it in a DDQ) then the report should be made available to investors. Where a hedge fund manager is serviced by an independent third party administrator, investors will seek assurance that the relevant controls and processes are in place at that third party.

### 5.3.2.6 External Service Providers

The primary service providers utilised by hedge funds today are the auditor, hedge fund administrator, executing and prime broker, legal counsel, custodian, valuation agent and third party cash management firms. Investors expect that service providers' roles, responsibilities and liabilities be in the best interests of the fund, clearly documented in the full Administration Agreement, Prime Brokerage Agreement or Custodial Agreement as appropriate. In the case particularly of Administration Agreements, there may also be in addition, a Service Level Agreement ("SLA" hereafter) and their performance periodically reviewed and documented by the manager with clear procedures for review/escalation. Further, investors expect regular contact between the respective hedge fund's board of directors and its service providers to monitor information flows, deal with issues as they arise and continue to look for ways in which the service provider can add value. There should be regular reviews of service against the fund's SLAs. The failure to appoint fit-for-purpose, proven and independent service providers may constitute a "yellow flag" warning in operational due diligence assessments.

Investors expect hedge funds to be independently audited by a specialist audit firm with a recognised record for auditing hedge funds. It is recommended that all the hedge fund manager's prime brokers and/or any other counterparties should be of a high quality. Likewise, investors expect for the hedge fund to have an independent third party fund administrator (see section 5.4 Valuation).

Investors expect the hedge fund manager to undertake a thorough due diligence process when recommending a service provider to ensure that they have the essential level of experience and expertise to carry out their roles to the required level. Managers should review enhancements and changes to service providers. A high level of change can be a cause for concern. The type of questions that should be considered

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are set out in the series of illustrative questionnaires for due diligence provided by the Alternative Investment Management Association (AIMA).

### Investor Expectations and Preferences

- Robust internal documentation and controls in place over each stage of the trade process cycle.
- External oversight of the firm's pricing process.
- Controls over the firm's cash process, which should be both preventive and detective.
- Managers are encouraged to implement STP, whenever practical.
- Firm's operations controls should be periodically tested, to assess the robustness of its measures.
- Frequent interaction by hedge fund senior management and third party providers.
- Well documented and thorough due diligence process pursued in appointing fund service providers, independent to fund board of directors.
- Fund service providers' roles, responsibilities and liabilities are in the best interests of the fund, clearly documented in a formal SLA.

## 5.4 Valuation

### 5.4.1 Content

This section describes the valuation processes and controls that investors should expect from a hedge fund firm. The process of how a hedge fund goes about determining the value of its investments is at the forefront of every hedge fund operational due diligence review. Pricing is probably one of the most sensitive and important areas in hedge fund controls. There is room for manipulation, fraud, or even simple errors in valuing assets, with valuations artificially boosting fund performance or smoothing "mark to market" returns. These are obvious reasons for the importance of having a clear valuation and pricing framework in place for the fund. A second critical reason for the importance of a robust valuation and trading process is to ensure the most accurate level of reporting for the fund's investments. This risk of inaccuracy can be mitigated through implementation of the pillars of a good valuation policy.

### 5.4.2 Requirements

#### 5.4.2.1 Independence

As mentioned above, separation of duties is a fundamental practice that should be viewed throughout the firm - no more so than in pricing. This has two aspects:

1. Separation from the front office: While the front office may be instrumental in the valuation of some assets, final authority should reside with the back office.
2. External oversight: External to the manager's organisation, the most effective way to ensure independence in the valuation process is for the hedge fund to appoint an independent third party administrator who is tasked with oversight over the hedge fund's pricing and valuation processes. Best practice calls for the administrator to calculate the fund's NAV, incorporating valuations derived exclusively from sources independent of the hedge fund manager. Investors prefer that valuations are performed by an independent party, and for each fund to have a full-service administrator. While this can be cumbersome to the manager, the benefits

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outweigh the costs. Daily pricing is preferred, where possible, and for any illiquid assets best practices call for a different level of review performed by a pricing specialist.

While best practices call for formal administration, this can be supplemented (or complimented) with an alternative, such as an agreed-upon procedure ("AUP" hereafter) from an independent auditor. Investors should be able to interview the administrator and review samples of the manager's valuation package. Investors will also review the audited financial statements and validate the valuation methodology.

### 5.4.2.2 Oversight

Investors expect the hedge fund back office/operations area to have oversight of the hedge fund's pricing and valuation process. The process should be supervised by an experienced professional with adequate authority. The personnel assigned to valuations should have sufficient experience and academic backgrounds to support the asset classes. For certain securities, the oversight from a valuation committee is of particular importance. The appointment of a valuation committee is also common if the hedge fund is a partnership vehicle as this is one way of mitigating the potential conflict of interests which may exist when the investment manager is also the GP (and therefore the governing body) of the fund.

The manager's valuation committee should consist of senior management, with the majority represented by members who are independent of the investment team. The powers of the committee, frequency of the committees meetings and how often the value of illiquid securities is revalidated, should be documented. The committee should meet regularly to review the entire portfolio, with particular attention paid to hard-to-value securities. Meeting minutes should be prepared and the valuation committee should have the authority and resources to consult a director and external specialists, as necessary. Investors should want to see evidence of an effective governance mechanism, including examples of any specific position that was discussed in the minutes.

### 5.4.2.3 Valuation Policy Document

Given that the pricing policy within the fund offering documents is generally vague, there should be a detailed documented pricing policy that describes the material aspects of the valuation process and valuation procedures and controls for each asset type (see *AIMA's Sound Practices Guide for Hedge Fund Valuation, 2007*)<sup>2</sup>. This should be constructed in consultation with the administrator, reviewed at least annually by the manager, approved by the board of directors and made available to investors upon request. The policy should explicitly clarify the role of each party in the valuation process, detail a comprehensive repeatable process as to how the fund manager will determine and reconcile the different types of instrument traded in its portfolio, and should include a practical escalation or resolution procedure for the management of any exceptional items. Policies should describe primary and secondary sources as well as the methodology used on esoteric asset types, back testing, controls to avoid "cherry picking" of broker quotes, and have defined and documented tolerance levels. The methodology and sources should be consistent over different periods and, where possible, multiple price sources should be used to verify the valuation of each position in a fund's portfolio. Investors will want to be satisfied that the valuation methodology is appropriate in the context of the fund's liquidity profile and terms, including fee structure.

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<sup>2</sup> AIMA's Guide to Sound Practices for Hedge Fund Valuation, 2007.

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### 5.4.2.4 Side Pockets

Many hedge funds hold a certain percentage of their portfolio in illiquid investments or distressed type securities. Further, some hedge fund investments can be held in a "side pocket", separate from the main portfolio. The market for these types of positions may be thinly traded and, in some cases, with the absence of a secondary market. Situations like these can leave the fund susceptible to portfolio valuation risk.

The treatment of side pockets is often a source of contention, and there are some best practices that all funds should follow:

1. The fund should have clear documentation that defines a side pocket.
2. The fund should provide investors with a description of assets which have been side pocketed and pricing at the point of side pocketing.
3. Performance fees should only be charged on realisation.
4. Current practice is that management fees can be charged at market value.

Third party valuation consultants with specialised knowledge specific to the assets in question should be engaged to independently verify the value assigned by the hedge funds to these positions. Where valuation memorandums are provided by third party specialists, these should be sent directly to the administrator.

### 5.4.2.5 Administrator

A good administration relationship can provide important third party oversight, but the administrator must have the appropriate capabilities and the fund manager should have the proper controls in place to monitor the quality of the administrator's work. Investors will often want to be able to contact the administrator and satisfy themselves that functions performed for the fund are acceptable to them. Roles and responsibilities should be defined in a clearly written SLA, and the manager should have a formal process to allow for a regular evaluation of their administrator's performance.

The administrator's systems should be commensurate with the manager's portfolio (i.e., size, volume, instruments), and should allow for extensive automation, wherever possible, to limit human error. The administrator should receive all portfolio information independent of the fund manager (i.e., from the prime brokers, OTC counterparties, etc.). The administrator should perform daily reconciliations of trades, portfolio and cash accounts, and these reconciliations should be automated wherever possible. There should be regular communication between the administrator and the manager throughout the month to allow for timely resolution of any trade breaks and other issues. The administrator should have access to portfolio data from both the manager and independently from the prime broker and also be able to obtain prices, independent of the fund manager. For assets with no observable prices that are fair valued by the manager, the administrator should review all supporting data. Monthly NAVs should be finalised in a timely manner that is commensurate with a fund's strategy. The manager should maintain close enough ties with the administration team to ensure properly qualified staff are working on their fund(s).

For certain strategies, a traditional administration relationship may not be appropriate and could be supplemented, or even replaced if deemed more appropriate, by a different level of third party oversight, including AUPs through an auditor or an independent valuation agent. The fund's SLAs with these alternative providers should be as clear and detailed as it would be with a traditional administrator.

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Many administrators produce a fund-specific monthly report independent of the manager, which details the pricing sources used (including the reliance on manager prices quantified as a percentage of NAV) and fund counterparties. This is an efficient and effective way of communicating this information and has been positively received, universally, by investors.

### Investor Expectations and Preferences

- Well documented trade, valuation and pricing policies.
- Robust internal compliance and controls in place over each stage of the trading cycle, trade authorisation, execution, confirmation, settlement, reconciliation and accounting.
- External oversight of the firm's pricing and valuation process.
- Where possible, multiple price sources should be used to verify the valuation of each position in a fund's portfolio.
- Well documented process regarding fund's side pocketing and valuation and treatment of fund's illiquid financial instruments clearly communicated to all investors.
- Fund-specific monthly report independent of the manager which details the pricing sources used (including the reliance on manager prices quantified as a percentage of NAV) and fund counterparties for both liquid and illiquid portions of the fund portfolio and fund counterparties.

## 5.5 Business Continuity/Disaster Recovery

### 5.5.1 Content

Business continuity planning ("BCP" hereafter) refers to a hedge fund manager's ability to continue operating in the event of a disruption to its business. Disaster recovery ("DR" hereafter) relates to a hedge fund manager's ability to restore itself back from a disaster event to the point where it was before the disaster occurred. BCP and DR planning spans all areas of the hedge fund organisation. All firms need to implement best practice procedures and infrastructure in order to protect the business in the event of natural disaster, terrorism, pandemics and other disruptions, although the BCP and DR plans should be bespoke in that they consider the risks of the manager's strategy.

### 5.5.2 Requirements

#### 5.5.2.1 Accountability

For a business continuity plan to be the most effective, investors expect it to be managed and supported by a senior hedge fund company official (usually the COO) or someone who holds a directorship or similar status in the company. If the BCP/DR plan is to be owned by a role such as the IT manager, it is very important to provide substantial proof that the business aspects have not been neglected. It is advisable that several different people in the company contribute to the plan including representatives from senior management, operations (including the back office area) and the investment area (front office). Investors expect that the key roles/responsibilities of each person or function involved in the recovery process will be identified and, where possible, more than one person is able to fill each key role.



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### 5.5.2.2 Planning

The first stage of any BCP/DR process is that a detailed plan is structured identifying the business critical activities and people across the whole organisation, the various disaster scenarios and the necessary tasks for recovery. A simple schematic should illustrate the company's systems and information flows. This will give an overall understanding of the scale and amount of systems and processes which need to be rebuilt in order for the company to fully operate.

As the company switches from its crisis and resumes to its recovery process, it is essential to have robust planning in place for the return to business as usual. A good BCP/DR plan will include the necessary steps to ensure a smooth transition. The plan should be documented in detail to include procedures, point person information and contact details for employees and service providers. Each department should have a primary and secondary point person, and the plan should also include call trees. The plan should include procedures that ensure the firm can operate in DR mode immediately or within a short period of time. It should include short, medium and long-term procedures to follow depending on the disaster.

The manager should require employees to read and sign/acknowledge that they understand the content of the plan, at least, on an annual basis and it should be accessible to employees via the firm's intranet to ensure employees can access information from home. Additionally, small credit card size information cards may be distributed and carried in employees' wallets for immediate reference. Finally, managers should have a clear plan for keeping its BCP/DR arrangements up to date.

BCP and DR planning spans all areas of a hedge fund organisation. Successful implementation of these plans requires the coordination of these different functions in order to keep the organisation functioning as a whole. The plan should be reviewed by IT and senior management, including compliance, on an annual basis, and generic copies of the plan should be provided to investors, on request.

### 5.5.2.3 Replication and Backup

All servers should be replicated to DR servers on a real-time basis. The offsite servers should be located far away from primary servers on a separate power grid, but should be accessible for testing and maintenance. The offsite data centre should be located in a reputable third party facility or purpose built office space managed by the manager. In addition to server to server replication, managers should backup servers to another form of backup media to ensure historical data is available, in the event of disaster, to both the primary and secondary facility. Regardless of the method, backup restores should be performed regularly by a member of the IT staff and data should be reviewed by compliance and members of the operations team to ensure that the data is readable. Many smaller managers may connect remotely to the replicated server offsite via VPN until replacement office space can be secured. In addition, recent advances in cloud computing now offer alternate back up options.

### 5.5.2.4 Disaster Recovery Space

The offsite data centre should be located in a secure third party facility or purpose built office space managed by the manager. Employee homes are not considered a best practice solution, although it is recognised that this is often the default solution for smaller managers. Office space should be located on a separate power grid from the primary office and should include the following equipment: furniture; computers; phones; printers; faxes; standard office supplies; petty cash; firm credit cards; first aid kits; generator (fuel supply for generator); redundant internet connections; UPS for user and server machines; backup cell phones; Blackberry's; non-cordless phones and

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laptops. Specific seating assignments should be determined ahead of time, and the majority of the firm's headcount should be guaranteed seats at this location. Machines and servers should be pre-configured and ready for immediate use.

### 5.5.2.5 Testing

Investors expect that all DR and BCPs should be frequently tested, without warning, at least once a year with the following tests carried out routinely with a desk walk through of the plans; a full test of the communications tree; a basic building evacuation drill; and a full or partial recovery to the firm's offsite facility. Further, it is advisable that tests are carried out so that all staff is aware of the necessary steps to take for successful execution of the firm's plan.

The internal IT team or third party IT provider should be responsible for monitoring the DR infrastructure on a continuous basis. Primary and secondary servers should be synched with one another, and this process should be checked by the chief technology officer. Backup data lines should be tested by shutting down primary data lines. Servers should be shut down to ensure automatic, seamless failover to secondary servers, at least quarterly. If IT is outsourced, an internal member of staff should audit the above procedures to ensure that tests are being carried out correctly. All employees should participate in a DR user test at least annually, and call trees should be tested, also at least annually. Testing should include a live trading day at the secondary office space, and home based users should be required to access the secondary network via Citrix or VPN. Test logs should be maintained and reviewed by senior management following each test.

#### Investor Expectations and Preferences

- Well documented BCP and DR.
- Dedicated DR/BCP crisis team for oversight of key issues.
- Plan is managed by senior management (COO, CFO).
- Proprietary data appropriately backed up and housed at an offsite venue.
- Appropriate level of documentation on the firm's recovery plan, with step by step guide to facilitate best return to operations.
- BCP/DR plan is regularly stress tested.
- Key person(s) risk of the firm is considered, with appropriate policies in place to address the same.

Note: *The AIMA Guide to Business Continuity Management for Hedge Fund Managers* (June 2006)<sup>3</sup> provides detailed information on how this process and plan can be prepared and maintained.

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<sup>3</sup> AIMA Guide to Business Continuity for Hedge Fund Managers, 2006

## Appendix      Working Group Members

### *Steering Group Members:*

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Andrea Gentilini	Union Bancaire Privée
Kurt Silberstein	California Public Employees Retirement Scheme (CalPERS)
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AIMA wishes to offer its sincere gratitude to all Steering Group members for their unstinting commitment that they gave towards the creation of this document

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