NAPF
Securing the future of pensions

Hedge Fund Standards

A Consultation Document from the Hedge Fund Working Group

A response by

The National Association of Pension Funds
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Introduction
The following response has been prepared by the National Association of Pension Funds (NAPF). The NAPF is the leading voice of workplace pension provision in the UK. Some 10 million working people are currently in NAPF Member schemes, while around 5 million pensioners are receiving valuable retirement income from such schemes. NAPF Member schemes hold assets of some £800 billion, and account for over one sixth of investment in the UK stock market. Members have in recent years built up material investments in hedge funds and with the move to diversify investment risk in pension funds continuing to gather pace, they can be expected to commit further assets to the sector in the years ahead.

We welcome this initiative by some of the major participants in the hedge fund industry and see the Working Group's proposals as a valuable step towards bringing greater transparency and accountability to the sector. Like private equity it owes a large measure of its success to the entrepreneurial character of its participants and it is important that this is neither used as an excuse to limit accountability nor that it is suppressed by excessive conformity to "good practice".

Much can be learnt from the development and application of the Combined Code which has evolved into a standard for listed companies which is now accepted as best practice in the UK and increasingly in other countries. As has been frequently pointed out "comply or explain" can only be effective if there is a dialogue between investors and companies (in this case funds) and ultimately some sanction for poor standards of compliance. Given the contractual nature of the relationship between investors and funds we are concerned that there may be a weakness in applying "comply or explain" to hedge funds.

The success of the proposed regime will depend heavily on the authority of the proposed Trustee, how hedge funds choose to meet the standards set for them and how institutional investors enforce the application of the standards among their managers.

Our answers to the questions posed by the Working Group are set out below:

Part 1

1. Are there further issues that should be addressed by the HFWG?

The agenda is comprehensive and addresses most of the issues raised by investors from time to time. However, we understand that there has been no direct input from investors at this point and perhaps as a result there is insufficient focus on ensuring that managers consult fully with their investors when planning to update or amend their policies.

We do question whether the sector may be accused of special pleading, in that the UCITS regime provides a framework for public funds, much of which relates to the same issues as are addressed in the Consultation. Could your analysis have usefully started with the UCITS regulations and identified those which are inappropriate, before adding those standards which would only apply to hedge funds? The standards will have to be developed into a practical regime with more detailed guidance than is included in the Consultation Paper. We see merit in developing this from the existing public funds regulations.

2. Conformity with the standards – what gives confidence that the standards will be conformed to?

Pension funds, which usually operate in a formal structure of decision-making, can be expected to request that funds apply the standards agreed following this consultation, but it will require buy-in from other investors as well to ensure compliance. As with the Combined Code, periodic reviews will be needed conducted by a group that has the support of a broad range of investors and funds. As noted earlier much of the success of the standards will depend on the standing and effectiveness of the Trustee.

3. Conformity with the standards – verification and disclosure of conformity. What would be the best forum for disclosing conformity with the standards?

Compliance (and on-going compliance) should be confirmed in fund prospectuses and reports.

4. Sector information - Would improvements to visibility, as suggested above, be useful?

Yes. We note the limitations of such data given the disparate nature of the industry.

4a What other areas of information related to the hedge fund industry would be of value, taking into account the constraints mentioned?

A number of hedge fund indices are now published which are used to indicate performance. To what extent is the industry already involved in setting standards for their construction and compilation? Is there room for improvement?

4b Would stakeholders see merit in firms who conform to the standards confirming this on their websites?

Yes.

5. Longer term and next steps – the proposal

A Board of Trustees has been proposed as the next approach to ensure continuity for the HFWG. Are you comfortable with this recommendation vs. other alternatives?

Yes. It is vital for the Board's credibility that it is seen to be independent of the funds for which it is setting standards. Investor representation on it will help, along with a strong independent presence.

5.1 If not, what other governance structure would be suitable?

n/a

5a What mandate should the trustees have?

At this stage we see no need to go beyond that described in the consultation. We anticipate, perhaps quite early on, challenges over non-compliance and the "explain" part of the regime. The trustees' response will be important in establishing their credibility with participants in the industry.

5b Should the funding be wholly provided by the hedge fund industry, or should the industry's users contribute?

Contribution to funding usually brings some rights to participation in decision-making. In this case the proposals are so evidently in the interests of hedge funds *if they are to develop their business with pension funds that it is hard to see why investors should contribute.*

6. **Longer and next steps – other issues. Do industry practitioners agree that there is a need for more hedge fund industry specific educational training, and if so, what relevant areas should the curriculum cover? Which of the relevant areas are not yet covered by existing training curricula and how should these gaps be filled? (eg complementing existing curricula, creating new stand alone training, etc)?**

   No comment

Part 2

1. **Introduction - The standards proposed in this document are largely based on disclosure rather than more prescriptive description of behaviour and practices. Would smaller hedge fund managers find such a disclosure-based approach difficult to comply with?**

   The regime will likely pose greater problems for smaller funds. However most of what is proposed is simply good business practice and the "comply or explain" approach should provide sufficient flexibility to enable them to demonstrate an appropriate level of compliance. As investors, pension funds are likely to assess non-compliance in the context of a hedge fund's stated risk profile.

1a **If the currently proposed practices do pose challenges for smaller funds, specifically which practices are toughest and how would the funds suggest addressing those issues in lieu of our recommendations?**

n/a

1b **Do the best practice standards strike the right balance between disclosure on the one hand, and the need for flexibility and innovation on the other?**

Pension funds will seek good levels of disclosure when investing in a fund and these are comprehensively discussed in the consultation. The standards give assurance of on-going conformity but should not inhibit flexibility or innovation.

2. **Disclosure to investors and counterparties.**
   Investment policy and risk disclosure - Would the disclosure standards as articulated be sufficient in breadth and clarity to enable potential or actual investors to make well-informed decisions? Are there areas where further disclosures are required?

These appear comprehensive. It is important that investors are consulted on proposed changes to policy and that there is an opportunity to disinvest if desired.

3. **Commercial terms disclosure - Would the proposed disclosures give investors a sufficient understanding of relevant commercial terms, such as fees, expenses and termination rights?**

   Yes. As above prior consultation on changes is necessary

4. **Disclosure to lenders/prime brokers/dealers - Are additional disclosure standards required for either creditors or other third parties to enable them to make well informed decisions?**

   n/a

5. **Valuation: segregation of the valuation and portfolio management functions - Given the importance of independence from the portfolio management function, are the improved valuation policies and procedures sufficient to meet the needs of investors? Should there be a more substantial role for administrators or other third parties in the valuation process beyond that set out in the HFWG report?**

   Investors expect that the use of a third party for valuation work will be the standard, with the involvement of the investment manager subject to detailed constraints. We expect that improved levels of disclosure will lead in due course to further changes in best practice.

6. **Valuation: difficult-to-value assets - Do the proposals for valuation of illiquid assets provide investors with sufficient confidence that pricing would be done in a fair, dependable and consistent manner?**

   Internal valuation of such assets should be discouraged as far as possible. But as above we see best practice evolving as disclosure improves.

7. **Prudential and risk issues - Are there other aspects of the proposed risk framework which are not laid out in the practices which should be considered? Please comment on the proposal in relation to each of the specific areas of risk for which best practice is proposed: a) Portfolio risk, b) Operational risk, c) Outsourcing risk.**

Will the above approaches provide investors and counterparties with sufficient understanding and comfort about the handling of risk?

The proposals provide comprehensive coverage of the key risks and how they should be monitored. Hedge funds operate in fast-moving markets and our only additional comments would be to ask if the proposals stress sufficiently the need for timely monitoring and reporting and if there is sufficient clarity around the internal reporting process, which may be a particular issue for small funds.

8. **Fund governance - Have we adequately covered the main issues in relation to this increasingly important area?**

   The key issues have been covered but it does seem wrong that the fund managers should assess the effectiveness of the FGB; that should be a matter for the FGB's members, as it is for pension trustees and plc boards. The FGB should, if appropriate report back to investors on any such review. The selection process for members of the FGB also should be transparent. It should include a majority of independent members as well as experts and a record of its meetings and attendance should be disclosed in the annual report.

9. **Market issues and activism - Are the governance and disclosure standards a useful addition towards market integrity? Would other market participants equally value clarification or improved definition as to what constitutes a" concert party"?**

   Yes. More traditional active investors are also unclear about the concert party rules and would welcome clarification.

10. **Proxy Voting - policy disclosure/CFDs/"empty voting"**

    These are all areas of concern to pension funds and improved disclosure of voting policy (perhaps along the lines of the ISC principles) would be valued. Likewise better dialogue on derivatives and "empty voting".
    The NAPF would be a willing participant in any such discussions.

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