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KAYE SCHOLER LLP

INVESTMENT FUNDS GROUP

Hedge Fund Industry Proposes Increased Disclosure

On 10 October, the Hedge Fund Working Group ("HFWG"), representing 14 leading hedge fund managers based mainly in the UK, published a consultation document on hedge fund standards. The consultation period runs until 14 December and the HFWG intends to issue a final report in January 2008.

The consultation document is in two parts. The first is addressed to a general audience and contains a summary of the proposed standards. The second part, designed for those with a professional interest in the sector, contains the detailed standards. Together, the two parts contain thirty questions on which responses are sought.

The new standards focus particularly on the areas of valuation, risk management, disclosure and fund governance. The HFWG has also recommended that hedge fund managers disclose more information about themselves on their websites and that more information about the industry be made available collectively to the wider public. By increasing the amount of reliable knowledge about what the hedge fund industry actually does, it is hoped that a more informed general view will result – a process the HFWG characterises as "enlightened self-interest".

The main best practice standards in the consultation document include:

- **Valuation:** Managers should ensure that the methodology for valuing complex assets is robust and transparent, and that the presence of illiquid and hard-to-value assets in the portfolio is disclosed, as are any conflicts of interest in the valuation process.

- **Risk management:** Managers should develop an approach to dealing comprehensively with risk, with particular emphasis on liquidity, so that they are able to cope with unexpected events and stresses. The stress on liquidity is particularly timely, given the current credit conditions.

- **Fund governance:** Managers should ensure that adequate structures are in place to handle potential conflicts between managers and investors.

- **Activism:** The HFWG recommends that regulators require all investors to disclose their interest in companies through holding derivatives such as CFDs; managers should also develop proxy voting policies, and they should not vote in respect of borrowed shares where they have no underlying economic interest.

The HFWG also proposes setting up a board of trustees that would assume responsibility for the standards and for updating them in the future, though it stresses that the board would not act as a regulator. It is hoped that the standards will be further developed over time in a global context. All this will inevitably require a permanent or semi-permanent secretariat to service the process, which the industry will need to pay for, though it may be possible for bodies already in existence, such as AIMA, to carry out some or all of the functions required.

The HFWG clearly hopes that these best practice standards will be adopted by the industry generally. In that context, it is perhaps unfortunate that the standards will not be confirmed by the Financial Services Authority ("FSA") as part of its industry guidance confirmation process, as that could only have assisted their adoption. However, since major hedge fund managers are represented on the HFWG, it may be that the HFWG is hoping that peer pressure will lead to the standards being widely adopted on a "comply or explain" basis.

In the wider context, the HFWG initiative needs to be considered alongside similar processes in the US, including the deliberations on hedge funds of the President's Working Group on Financial Markets. Hedge funds operate globally, and ultimately a global standard of disclosure will need to be agreed upon.

It remains to be seen how large an impact the HFWG proposals, if implemented, will have on the industry. To a large extent, as the report acknowledges, the proposals build on industry best practices. But the increased stress on disclosure is likely both to counter general criticism of the secrecy with which hedge fund management is conducted and result in investors obtaining more information relevant to their investments.

New York Office
+1 212.836.8000

Chicago Office
+1 312.583.2300

Los Angeles Office
+1 310.788.1000

Washington, DC Office
+1 202.682.3500

West Palm Beach Office
+1 561.802.3230

Frankfurt Office
+1 49.69.25494.0

London Office
+1 44.20.7105.0500

Shanghai Office
+1 86.21.2208.3600