Hedge Fund Best Practices: An Overview

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Introduction

This article seeks to summarize the best practice guidelines issued by various professional and regulatory bodies, including the Guide to Sound Practices for Asian Hedge Fund Managers (Dec 2004) issued by the Alternative Investment Management Association (AIMA)[1], the Best Practices for the Hedge Fund Industry (15 Jan 2009) issued by the Asset Managers' Committee (AMC) of the President's Working Group on Financial Markets in the US[2], and the Managed Funds Association's (MFA) Sound Practices for Hedge Fund Managers (2009 Edition)[3].

In particular, this article focuses on the recommendations regarding the following issues:

1. Investment and risk management
2. Disclosure and side letters
3. Trading and operation

We will examine these issues in turn.

Investment and risk management

It is well recognized that risk management is not to eliminate risk all together. Instead, as the AMC's best practices suggest the aim of risk management is to ensure that the potential risks are consistent with the funds' risk profile. AMC also recommends fund managers to disclose the risk management framework to investors in order to allow them to make informed investment decision and evaluate the performance of the funds.

Regarding the risk management framework, AMC suggests the following five-step approach. First of all, managers must spot out the major risks which the portfolio is facing. Secondly, the managers have to measure the major categories of risk, such as liquidity risk, operational risk and market risk. Whether a category of risk should be regarded as a major category depends on a number of factors including fund size and the fund's investment strategy. Thirdly, there must be policies and procedures governing the assessment and monitoring of risk. Fourthly, risk ought to be regularly monitored, and lastly, it must be done by personnel equipped with the necessary skills.

[1] Available online at http://www.aima.org/download.cfm/docid/6E4D038B-F020-4B75-81305D3E817067A9 (accessed 15 July 2013).
[2] Available online at http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf (accessed 15 July 2013).
[3] Available online at https://www.managedfunds.org/wp-content/uploads/2011/06/Final_2009_complete.pdf (accessed 15 July 2013).

AIMA's sound practices also contain some practical and specific recommendations. In terms of risk measurement, AIMA is of the opinion that if possible the risks must be translated into measurable risk factors, and risk should be measured taking into account its impact on the portfolio and the probability of the risk materializing. AIMA also highlights the possible interplay between different categories of risk. Specifically, in terms of implementation, AIMA proposes that investment restrictions should be documented. Stress tests have to be conducted at particular intervals and when the managers think fit, and a formal comprehensive stress test ought to be conducted at least once a year. The independence of the risk review mechanism must also be protected.

From the above discussion, we notice that the MFA and AIMA both highlight the elements of competency and independence respectively when it comes to the risk control mechanism. In our opinion, both qualities are of paramount importance in the risk management mechanism. On the other hand, these two attributes may be mutually exclusive in some rare situations, as we may have seen in the context of asset valuation (i.e. when the manager himself, instead of an independent third party, is in a better position to evaluate a particular piece of asset). In this case, it is submitted that there must be adequate procedures in place to limit the discretion of the manager and to ensure the integrity of the risk management framework is not compromised.

In light of the tightening regulatory regimes in a number of jurisdictions, the MFA identifies legal and compliance risk as one of the possible risk categories, and advises managers to adopt a compliance manual to reduce non-compliance risk. MFA also suggests the appointment of a Chief Compliance Officer.

We agree with the above best practice guidelines and in particular, one must not lose sight of the legal and compliance risk rightly identified by the MFA. Non-compliance can result in serious damages to the fund's reputation. We are also in agreement with AIMA when it comes to risk measurement, and, as AIMA recommended, risk should be measured in terms of the likelihood of the risk materializing and its impact on the portfolio.

Disclosure and side letters

Investor relationship and adequate information disclosure are both key aspects of hedge fund management. Investors have the right to sufficient protection, and the best practice guidelines contain a number of useful recommendations in this regard.

AIMA advises that relevant information must be disclosed to investors on a timely, regular and consistent basis. The information required to be disclosed includes portfolio information and performance information. The information is provided to enable investors to understand how accounts are invested and make informed decision. If there are important changes in account management, changes to key investment personnel or changes in infrastructure or key services providers, exceptional disclosures have to be made to investors.

Investors should be promptly furnished with the relevant information. Specifically, once the net asset value is calculated and finalized, disclosure must be promptly made.

An updated contact database has to be maintained. The managers should commit adequate resources to respond to investors' enquiry, and investors should be able to expect timely response irrespective of their investment amount. Investors should be treated equally regardless of their personal wealth.

A thorny issue in this area is the disclosure of side letter. The AMC's Best Practices contains a useful disclosure guideline. It is accepted that the use of side letter can be beneficial to all investors, and that side letter does not necessarily affect other investors negatively. Nevertheless, there will be cases where side letters may be detrimental to some investors in certain aspects, and in such cases relevant disclosure should be made to allow investors to assess the possible implication on their investment.

The managers may have to disclose both the existence and the terms of the side letters. Specifically, managers should disclose terms which confer enhanced control rights or preferential liquidity or redemption rights to a particular investor. Terms that significantly change the investment program as stated in the PPM ought to be disclosed too.

Trading and operation

A number of suggestions have been made in relation to trading and business operation. The AMC's Best Practices emphasizes three key aspects, namely the operational and accounting functions, core operational infrastructure, and the appointment of a Chief Operating Officer.

Firstly, counterparty and key service providers have to be carefully selected and managed. There must be a proper accounting and operational policy in place, and in particular business operations and the investment function ought to be appropriately separated. More specifically, cash, collateral and margin have to be properly managed. Moreover, a disaster recovery process should also be prepared in advance.

Secondly, management should ensure that the funds are equipped with the necessary infrastructures taking into account the fund size and other relevant factors. Automation, if possible in light of fund size, is also recommended so as to reduce settlement risk.

Lastly, AMC also recommends the appointment of a Chief Operating Officer or officer with similar duty, and the collaboration between such officer with both the investment managers and management.

We agree with the suggestions of AMC, and more specifically we also wish to highlight the importance of counterparty selection. Counterparty risk is one of the major risks that a fund faces and improper counterparty selection can expose the fund to unnecessary risk.

AIMA, too, has issued guideline on portfolio administration and operation. In particular, concerning core infrastructure, we wish to highlight AIMA's observation that the fund's information system ought to be secured. This is an important piece of advice, since nowadays funds rely heavily on information systems with such systems requiring protection. Moreover, sensitive client information within the system should be secured to mitigate risk of compromise.

AIMA also emphasizes the need to appropriately select, manage and monitor key service providers such as brokers and fund administrators. This is another piece of advice that one should bear in mind in light of the importance of such key service providers. For example, AIMA recommends that in every transaction, the fund managers should know which executing broker and prime broker are handling the trade.

The MFA also makes some relevant recommendations. Specifically, trading activities ought to be documented. In addition, we agree with MFA's suggestion that the trading and operational policies have to be reviewed regularly.

Other issues

The various best practice guidelines also make recommendations regarding other issues such as portfolio valuation and business continuity management. For more details, readers can refer to these best practices available on the internet.

Conclusion

While these best practices are of course not binding, they are no doubt of considerable value. If one encounters the aforementioned issues, referring to these best practice guidelines and talking to your compliance consultant would be helpful.

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