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Hedge Fund Standards Board—Recent Developments

The purpose of this advisory is to outline recent developments in respect of the Hedge Fund Standards Board (HFSB) and its continued and growing importance as an industry benchmark for hedge fund managers.

Background

On 22 January 2008 the Hedge Fund Working Group (HFWG) published its final report containing best practice standards for hedge fund managers following consultation with the hedge fund industry. The outcome of the HFWG was the establishment of the HFSB as well as recommending voluntary standards that seek to address five key areas: disclosure; valuation; risk; the governance of funds; and hedge funds' conduct as shareholders. Compliance with the voluntary hedge fund standards is on a "comply or explain" basis.

The report contained recommendations for hedge fund managers to adopt in order to manage potential and actual conflicts of interest with those of investors, including an independent process for valuing portfolios and implementing robust governance of funds. The report also recommended enhanced disclosure for investors and the implementation of comprehensive risk management procedures.

Recent Developments

In 2009, the HFSB launched two separate industry consultations relating to: (i) Hedge Fund Redemptions (CP1/2009), and (ii) Administration and Safekeeping (CP2/2009). CP1/2009 relates to the handling of redemptions and, in particular, issues arising when significant redemption pressure occurs, as experienced in the second half of 2008 and early 2009. The proposed "Standards and Guidance" seek to address potentially damaging externalities that can develop in such situations, keeping in mind the principle of fair treatment of investors. CP2/2009 relates to the mitigation of the risk of fraud and misrepresentation that can arise if the safekeeping and administration of hedge fund assets is handled in house. The proposed "Standards and Guidance" seek to establish the practice of appointing a third party for the safekeeping and administration of hedge fund assets complemented by adequate disclosure to investors.

The result of the consultation has led to draft amendments to the HFSB "Standards and Guidance," in particular to Standard 2 (Commercial Terms Disclosure) and Standard 17(a) (People and Governance: Operational Risk). Standard 2 relating to redemptions will be expanded to provide, amongst other things, a requirement to provide clear guidance in respect of notice periods, details of and circumstances in which redemption notices can be revoked, details of any potential redemption penalties, details of any lock-up periods,

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and an indication of circumstances in which normal redemption mechanics might not apply or may be suspended. Standard 17(a) has been amended to include two additional Standards: (i) a hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to appoint one or more third parties, independent of the manager, to be responsible for the safekeeping of the property of the fund, and (ii) a hedge fund manager should do what it reasonably can and encourage the fund governing body to appoint a third party, independent of the manager, with responsibility for fund administration (including calculation of the NAV and the maintenance of accounting records of the fund) in order to ensure the segregation of functions and the avoidance of conflicts of interest in relation to the provision of fund administrative services.

The new Standards and Guidance will become effective on 1 August 2010.

Following on from the consultation and the publication of the new draft Standards and Guidance, alternative asset manager Aspect Capital and Henderson Global Investors are among five hedge fund managers who have committed themselves to the HFSB Standards. There are now 58 signatories to the Standards which have been supported by the UK Financial Services Authority.

The HFSB standards, as we have previously advised, have become something of an “industry standard” for hedge fund managers operating in Europe. We strongly recommend that even for non-signatories, the Standards should be complied with. Whilst there is no actual precedent to date, it is very likely that in any future dispute between a fund and its investors, a court or a financial regulator may look to see if the Standards have been adhered to by a fund manager in its dealings with an investor. Indeed the Malta Financial Services Authority has specifically adopted the Standards and applies their disclosure requirements to the content of prospectuses. Compliance with the Standards comes through increased disclosure (e.g., in prospectuses and other documentation) and transparency when dealing with investors and, specifically, implementing the Standards and Guidance across hedge fund managers’ middle and back office functions, including outsourced providers. The Standards, once complied with, should also be fully disclosed in any constitutional and marketing documentation sent to investors, particularly where these are European investors. The Standards are also clearly of relevance to investors undertaking due diligence, who should not only ask whether a manager is a signatory to the Standards, but also, whether or not that is the case, whether and to what extent the manager and the fund actually comply with the Standards.

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