Principles for Australian Institutions investing in Hedge Funds

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Mr. Bruce Tomlinson (Chairman), Sunsuper
Dr. Jon Glass, Media Super
Mr. Craig Turnbull, Local Government (NSW) Super
Mr. Tom Gillespie, ARIA

Kim Ivey
President
AIMA Australia

DISCLAIMER

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Preamble

This document intends to provide guidance to hedge fund managers regarding their dealings with Australian institutional investors. The Principles are a general indication of investors' preferences, the more closely to which a manager adheres, the better the managers' ability to progress through due diligence. These principles are not enforceable standards.

- They focus on generic operational and business areas, and are largely silent on investment management areas which can vary widely based on investor preferences and hedge fund manager strategies.
- Investment process and governance practices vary across superannuation funds, so that trustees or directors may or may not be involved in manager appointment decisions.
- Hedge Fund Managers (HFM) should be aware of the role of the two Australian regulators ASIC (www.asic.gov.au) and APRA (www.apra.gov.au) , and should stay abreast of any updates to regulations as they occur.
- We encourage awareness of more universal industry standards and guidelines such as Hedge Fund Standards Board (www.hfsb.org) and AIMA's Guides to Sound Practices (http://www.aima.org/en/knowledge_centre/sound-practices/guides-to-sound-practices.cfm)

This document does not lay claim to universality by inclusion or emphasis.

Introduction

We have grouped these Principles into four broad sections pertaining to the HFM, covering **governance, fund operations**, **business management & operations**, and **risk management**.

Governance

- We recommend that a HFM Board should consist of a minimum three directors, with a majority of Directors being independent, and possessing relevant experience;
- We would like Boards to play a key role in the appointment, review and if required, replacement of key service providers such as investment manager (if external), auditor, administrator, custodian, lawyers and prime broker;
- The Board is responsible for ensuring all funds managed by the HFM has an investment strategy and process document that details (at a minimum): investment philosophy/approach, portfolio construction, risk management, and authorized investments;

- The Board should be responsible for monitoring compliance with AFSL obligations and internal policies such as investment strategy and process, other regulatory compliance, and conflicts of interest (including personal trading);
- The Board should be responsible for a valuation policy (striking NAV), gating and other redemption restrictions, and use of side pockets for all Funds managed by the HFM;
- Offering documents – must be transparent and fair, with terms such as liquidity/redemptions appropriate to the specific strategy;
- All Shares or units in a comingled investment vehicle should provide relevant voting rights to investors which must be protected;
- Audit – we believe independently audited annual financial accounts for an investment vehicle are mandatory, ideally within 90 days of the Financial Year end;
- Audited financial accounts must provide transparency on items such as fees, expenses, and comply with relevant tax and accounting standards;
- As part of a Board's obligation for material disclosure to investors, we would like to see immediate notification of any litigation or pending litigation against any individual, company or trust associated with the HFM.

Fund Operations

- Valuation independence – the use of an independent valuation agent or fund administrator is mandatory. Full disclosure of any manager marked assets must be made;
- Non-marketable assets – should be side-pocketed and priced by external experts where no market quotes are available;
- Valuation & pricing frequency – minimum standard is monthly NAV, with weekly estimates recommended;
- Service providers - independent administrator required; at least one prime broker and multiple counter-parties when OTC instruments are used are highly recommended.
- Cash management – use of segregated cash accounts with independent custodian is required. Minimal cash to be retained by prime broker if held in the PB's commingled accounts ;
- We recommend a clear segregation of front and back office staff and systems with proper authority levels on cash and asset movements;
- Independent (of front office) and experienced compliance and risk staff. Business Continuity Plans & Disaster Recovery Plans are in place and regularly tested.

Business Management & Operations

- Base Management Fees – If a HFM's investment strategy's alpha is impinged by asset size, we recommend that base management fees should be designed to prudently cover all operating costs and future capital investment, and not to generate significant profits from unconstrained asset growth ;
- Performance fees – perpetual high watermarks are strongly recommended, with appropriate hurdles and caps encouraged;

- If the HFM business is found to be dependent on a single individual, then a Key man clause is generally required – often funds are sought to be liquidated within 90 days of any key man incapacity or can be put to a shareholder vote;
- Business ownership – our preference is to see a majority of the equity in a HFM business independently owned by active (non-retired) Principals in the business and in a structure that encourages retention of key employees;
- Assets under management capacity – explicit capacity targets should be communicated to investors regularly;
- Alignment of interests between the HFM and their investors - our preference is to see at least 25% of the liquid net worth of key investment staff to be invested in fund(s) managed by them; Investment staff bonuses are encouraged to be structured and paid as deferred compensation over an extended period and wherever possible, re-invested in the fund;
- Capital Structure & Insurance – our due diligence supports HFMs which have adequate levels of both equity capital and professional liability insurance to be retained by the HFM;
- Performance reporting - HFMs should be aware that the pricing policy of various Australian superfunds will vary from daily to monthly and that products will need to conform to these pricing standards. Performance attribution by Australian institutional investors is mandatory.
- Investor Relations – both HFM investment and IR staff should be available for regular investor updates;
- Most Favoured Nation (MFN) & side letter agreements are often negotiated with HFMs on a fair and reasonable basis;
- Investor mix – Our preference is to see a majority of other institutional investors, diversified by type and geography;

Risk Management by HFM

Hedge Fund strategies and their implementation are typically idiosyncratic requiring customised reporting of information and exposures necessary to identify and manage risks. Moreover, investors also require some common approaches to demonstrate good management of risks and gather important information and exposures:

- Strategy and sector risk exposure – minimum monthly details of investment risk (long exposures, short exposures, leverage levels, factor exposures) in the form of raw dollar exposure, appropriate risk statistics (i.e. probability of loss, potential drawdown, standard deviation, Value-at-Risk, Conditional Value-at-Risk…) and stress tests / scenario analysis;
- Position disclosure – recommend full disclosure of positions when requested or the use of a Hedge Fund risk aggregator service;
- Counterparty and Operational risks require regular quantification and evidence of on-going identification and management of those risks;
- Liquidity risk – investors to receive all capital within 1 year or less, without any constraints; monthly disclosure of fund liquidity profile based on modest turnover and average volumes.