Dubai Financial Services Authority

CONSULTATION PAPER NO 50

3 JULY 2007

PROPOSED HEDGE FUND CODE OF PRACTICE

CONSULTATION PAPER NO 50

PROPOSED HEDGE FUND CODE OF PRACTICE

Why are we issuing this paper?

1. When the Collective Investment Law 2006 and the Collective Investment Rules (i.e. the CIF regime) came into effect in April 2006, the DFSA indicated that it expects Operators of Hedge Funds to have proper regard to guidance and best practice standards issued by the DFSA and leading industry bodies. The DFSA also announced that it will develop a Code of Practice for Hedge Funds in consultation with the industry after the CIF regime has been in operation for a year. This Consultation Paper seeks public comment on the proposed Code of Practice (the Code) for operating Hedge Funds in the DIFC.

2. Hedge Funds often have significant assets under management. They have been particularly attractive to institutional investors seeking to enhance their returns through sophisticated and innovative investment strategies. Where properly managed, Hedge Funds can contribute to the efficiency and liquidity of global capital markets. Conversely, where not properly managed, Hedge Funds can have a significant adverse impact not only on investors but also on market integrity and market confidence. These factors and the collapses of some large Hedge Funds recently have highlighted the need for increased regulatory attention on Hedge Fund operations. In line with the DFSA's risk based approach to regulation, we have adopted a principles based approach by setting out best practice standards, instead of prescriptive rules, to promote certainty without removing flexibility.

Who should read this paper?

3. These proposals will be of primary interest to Authorised Firms operating or proposing to operate Public or Private Hedge Funds in the DIFC and also to their third party service providers such as persons undertaking investment management, asset valuation, prime broking and other services for Hedge Funds. We also think that these proposals will be of significant interest to the wider hedge fund community, especially coming in the wake of the recent initiatives such as the projects undertaken by the European hedge funds industry and the US President's Working Group on Financial Markets for developing best practice standards for hedge funds.

How is this paper structured?

4. The Code sets out best practice standards under 9 Principles. Where we have used capitalised terms, they are defined terms set out in the GLO Module of the DFSA Rulebook. We have included some of those relevant definitions in Table A of the draft Code. We have also included in paragraph 10 a brief overview of the CIF regime to promote a better understanding of the regulatory framework on which the proposals are built.

How to provide comments?

5. We have identified a number of specific issues relating to the proposed Principles on which we seek your comments. You may also comment on any other related issues or aspects.

6. All comments should be forwarded to the person specified below. You may, if relevant, identify the organisation you represent in providing your comments. The DFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise at the time of making comments.

What happens next?

7. The deadline for providing comments on these proposals is **4 October 2007**. During the consultation period, we propose to undertake discussion with Authorised Firms and focus groups. If you intend to participate in these discussions, you should contact the person specified below as soon as possible.

8. Once we obtain your comments, we will consider if any further changes or refinements are required to this Code. At the time of adopting the Code, we will remove the Guidance relating to Hedge Funds under CIR Rule 13.6.4, as the Code covers in more detail the matters which are addressed in that Guidance.

9. As the Code contains only proposals at this stage, they should not be acted upon as settled policy. We will notify you by information on the DFSA website when the Code is finalised and adopted.

Comments and interest to participate in consultation should be directed to:

Mrs Dhammika Amukotuwa
Legal Counsel – Policy and Legal Services
DFSA
Telephone: 971 (0)4 362 1509
PO Box 75850
Dubai, UAE

or e-mailed to: damukotuwa@dfsa.ae

An overview of the CIF regime

10. Some of the key features of the CIF regime which apply to Hedge Funds, being Collective Investment Funds ("CIF"), include the obligations that the Operator of the Fund must:

    (a) be legally accountable to investors of the Fund for the operation and proper management of the Fund. In doing so, the Operator must avoid conflicts of interests and act in the best interests of the investors. These underlying obligations apply to the Operator even if it uses third party service providers such as fund administrators, investment managers and custodians;

    (b) be an Authorised Firm whose licence authorises it to Operate a CIF. It may also need additional authorisations for Financial Services it may conduct in operating the Fund, such as Fund Administration;

    (c) appoint an Eligible Custodian or a Trustee to hold the Fund property;

    (d) appoint a registered auditor to audit the Fund;

    (e) not offer or market the Units of the Fund to Persons other than Qualified Investors (i.e. high net worth individuals or wholesale investors who meet the definition of Client in COB 3.3.2) and ensure, in the case of Private Funds, no more than 100 Investors participate in the Fund and they do so by private placement;

    (f) register the Fund with the DFSA, if it is a Public Fund and, give the DFSA 14 days prior notice before the issue of Units of the Fund, if it is a Private Fund;

    (g) comply with the relevant Prospectus and disclosure requirements, depending on whether it is a Public Fund or Private Fund; and

    (h) if it is a Public Fund, have independent oversight arrangements that meet the specified standards.

Why have we adopted a principles based approach for best practice standards?

11. Within the legal framework provided by the CIF regime as outlined above, we have adopted a principles based approach to developing best practice standards for Hedge Funds, instead of a more detailed and prescriptive approach. This approach is designed to promote certainty without removing the flexibility for industry participants to find alternative means to achieve similar results. However, where an Operator adopts the best practice standards in the Code, it will provide strong evidence to support compliance with the relevant requirements in the CIF regime to which the standards relate.

Issue for consideration
Does the industry prefer a more prescriptive approach, at least in some areas of Hedge Fund operations covered by the Code? If so, why?

What is the rationale for choosing these particular Principles?

12. The nine Principles under which we propose best practice standards are designed to address a number of risks that are more specific to the operation of Hedge Funds, than to other types of Collective Investment Funds. We have identified the rationale for addressing the relevant risks under each Principle. In general, these principles flow from the overarching obligation of Operators of Hedge Funds to have adequate systems and controls to address risks inherent in the operation of a Hedge Fund. In doing so, Operators are required to have due regard to the nature of strategies and investment processes employed by the Fund and the roles played by various service providers involved in the operation of the Fund, such as fund administrators and prime brokers (see CIR Rule 13.6.4).

Issue for consideration
Are there any other significant areas of risks relating to Hedge Funds which should be addressed in the Code? If so, what are they and how should they be addressed?

MANAGING OPERATIONAL RISK

Resources and skills

13. Principle 1 and the associated best practice standards (see paragraphs 3 – 6) are designed to address the risk of lack or loss of relevant expertise at the Operator and third party service provider level that can seriously impair the Operator's ability to effectively implement investment strategies of a Hedge Fund. Following broad measures that can generally be adopted to mitigate this risk, we have provided detailed guidance relating to prime brokers.

Issues for consideration
Are there any other key aspects or issues relating to resources and skills that are relevant to Hedge Fund operations which should be dealt with by best practice standards? If so, what are they and how should they be addressed? Do you agree that prime broker issues should be addressed as a skills and resources issue? If not, how should they be addressed?

Investment strategy and process

14. Principle 2 and the associated best practice standards focus on measures that can be adopted by Operators of Hedge Funds to ensure that the investment processes adopted by them are robust and flexible and are best suited to the investment objectives and risk profile of the investment strategies of the Fund. See paragraphs 8 and 9.

15. Principle 3 and associated best practice standards are designed to address trading related risks such as price overrides and failed trades. Hedge Funds are particularly vulnerable to these risks due to high volume trading and the use of multiple third party service providers often located in remote locations, which make it harder to assess the effect of such overrides and failed trades on the Fund's overall exposures. See paragraphs 10 – 12.

Issue for consideration

Are there any other issues arising in relation to investment and trading processes of Hedge Fund operations which should be addressed by best practice standards? If so, what are they, and how should they be addressed?

Back-office procedures

16. Principle 4 and associated best practice standards deal with risks arising from backlogs in trade confirmations. These assume a special significance in Hedge Fund operations which involve high volume trades as backlogs can make it harder to ascertain and manage exposures to market and credit risks, by both the Funds and the counterparties involved. See paragraphs 13 – 15.

Issue for consideration

Are there any other back office functions related issues other than backlogs in trade confirmations which need to be addressed in the Code? If so, what are they, and what best practice standards are appropriate to address them?

PORTFOLIO RISK MANAGEMENT

17. Principle 5 and associated best practice standards deal with portfolio risks. Portfolio risks to which Hedge Funds are exposed (such as market, liquidity and counterparty risks) are quite distinct from the operational risks addressed under the previous principles. Because of the extensive use of leverage and derivatives in the investment strategies employed by Hedge Funds, the impact of these risks can be rapidly magnified well beyond the impact such risks can generally have on conventional Funds, and hence the need for best practice standards to mitigate the effect of such risks on Hedge Funds. See paragraphs 16 – 23.

Issue for consideration

Are there other portfolio risks that are not addressed by the proposed best practice standards proposed? If so, what are they and what best practice standards are appropriate to address them?

FUND VALUATIONS

18. Principle 6 and associated best practice standards aim to mitigate risks to Fund valuation processes. This is quite a high risk area for Hedge Fund operations as they often invest in hard to value complex financial instruments, which rely on mark to model, rather than mark to market valuations. Absence of adequate processes and mechanisms to ensure proper valuation of the Fund assets can result in price distortions that seriously mar investor confidence and affect market stability. Due to these concerns, the International Organisation of Securities Regulators (IOSCO) has in March 2007 published for public consultation a set of draft principles for valuation of Hedge Fund portfolios. Although the consultation period on these proposals has just ended and hence the final principles are not yet settled, given the DFSA's commitment to meet international best practice standards, we have taken into account those proposals when developing our proposals (see paragraphs 24 and 25).

Issues for consideration

Are there other measures that can be adopted by Operators of Hedge Funds to ensure more accurate valuations? If so, what are they?

Are there other measures that can be adopted by an Operator of a Hedge Fund to ensure integrity and reliability of valuation inputs which are provided or influenced by the investment manager? If so, what are they?

CONFLICTS OF INTERESTS SUCH AS SIDE LETTER ARRANGEMENTS

19. Principle 7 and associated best practice standards deal with conflicts of interests such as those that may arise from side letter arrangements. This remain a contentious issue as it seems to be a prevalent practice among Operators of Hedge Funds to enter into side letter arrangements to provide undisclosed benefits and concessions to only some investors. We are of the view that this practice would generally amount to a breach of some of the Operator's fundamental statutory and fiduciary obligations, particularly those relating to treating investors of the same class equally and investors of different classes (as between classes) fairly. However, we recognise that in very limited circumstances, an Operator may be able have side letter arrangements without breaching these obligations. These circumstances encompass side letter arrangements under which additional periodic reports are made available to all investors alike, with adequate disclosure of the terms and conditions including any applicable fees. See paragraphs 26 and 27.

Issues for consideration

Should the DFSA adopt a more stringent approach to the issue of side letters? If so, why?

Are there other types of conflicts of interests that should be addressed through best practice standards? If so, what are they, and how should they be addressed?

20. Principle 8 and associated best practice standards deal with issues relating to possible abuses of market sensitive information. While not unique to Hedge Fund operations, the potential for abuse of such information is higher in Hedge Funds due to high volume trading, close relationships with counterparties and performance based remuneration involved. See paragraph 28.

Issue for consideration

Should the issues relating to market abuses be left to be dealt with through the applicable legal requirements, rather than any additional best practice standards as proposed? Why do you think so?

FUND OF HEDGE FUNDS INVESTMENTS

21. Principle 9 and the associated best practice standards focus on risks that arise from the use of a Fund of Funds structure by Operators of Hedge Funds. Implicit in an investor's agreement to invest in a Fund of Hedge Funds is the reliance that the Operator will have sufficient skills and resources to ensure on-going suitability of the underlying Hedge Funds to justify additional fees resulting from such structures (see paragraphs 29 – 31).

Issue for consideration

Are there other risks relating to the use of a Fund of Hedge funds structure which are not addressed through the proposed best practice standards? If so, what are they, and how should they be addressed?