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December 14<sup>th</sup>, 2007

Dear Mr Deinet

I am writing as the chair of the Shareholder Responsibilities Committee of the International Corporate Governance Network (ICGN), which as you may know is a global membership organisation of institutional and private investors, corporations and advisors. Our membership spans over 40 countries and the investor members are responsible for global assets of \$15 trillion. The aim of the ICGN is to contribute to raising standards of corporate governance through the exchange of ideas and information across borders and the development of best practices.

ICGN believes that both investors and investees have responsibilities to each other and, as fiduciaries, to the ultimate beneficiaries on whose behalf investments are made. For that reason we have released detailed principles of shareholder responsibilities encouraging institutional shareholders to behave like responsible owners, attend to their own governance, use their voting right judiciously in the interests of their beneficiaries and to engage with companies in the listed sector. These principles, we believe, provide a necessary symmetry and balance with our principles of shareholder rights. We consider that this balance of investor rights and responsibilities is relevant to all asset classes.

We are pleased to have this opportunity to provide feedback to the Hedge Fund Working Group. The approach taken by the Working Group is a sensible one, allowing those who carry on the business of hedge funds to develop a Code of Best Practice which is capable of performance and comes with the “ownership” of leading practitioners in the UK.

ICGN accepts that Hedge Funds have become a significant source of fruitful investment for pension funds and other institutional investors, and that they are likely to remain a permanent

feature of the investment landscape. Their availability to retail investors undoubtedly requires greater and perhaps different considerations, but we will make no attempt to deal with the implications of retail investment in Hedge Funds in this response.

Two other approaches contended for by the Working Group are also supported:

- The first is that any Code of Practice which flows from the Working Group's final recommendations will be proposed and seen as a "living document" capable of refinement and change as it is tested by experience, and as new and different investment methodologies are adopted by Hedge Funds. The fact that there is no legal or universally accepted definition of the phrase "Hedge Fund" will almost certainly mean that new variants of non-standard investment practice are likely to find themselves described as Hedge Funds among the many variants already grouped there, however unrelated they may be to each other.
- The second is the decision to adopt the familiar (to the U.K. and some other jurisdictions at least) "comply or explain" test of conformity with the new Best Practice Code. Since the hope expressed by the Working Group, that some thing that can be demonstrated to have derived from the industry itself and to have worked, might spread to other jurisdictions, it is important that it be as familiar in its structure and requirements of fund managers as possible.

ICGN accepts that adherence to the code will be voluntary, and that adherence will be enhanced if investors create demand for it, as well as differentiating (all other things being equal) between compliant and non-compliant hedge fund managers. Large institutional investors and pension funds with access to asset consultants, have the means to seek out best practice managers when allocating funds and the Code of Practice will be an extremely useful template for the making of such assessments.

You will recognise that ICGN has historically focused most of its attention on listed equity markets. That is not to say that its members are not active participants in other asset classes and private markets, but this response begins with the effects of Hedge Fund activity in equity markets. We will in response to the questions put to us in the Consultation Paper, endeavour to comment on those aspects first, with less emphasis on Hedge Fund activity in fixed interest, currency and other markets. We have thus adopted for the purposes of our particular comments the "Defining Features of Hedge Fund" distinguished from traditional products on page 11 of PART 1 of the Consultation Paper.

That is to say leveraged long-short equity funds using derivatives seeking absolute returns.

It may be worth observing that Hedge Funds rely to a very high degree on the skill of the manager(s). Tracking the continuing involvement of key personnel and their alignment with

investors by means of co-investment and/or reward systems are central factors in manager selection. A second observation is that top quartile performing Hedge Funds have little difficulty in attracting investment funds, quite the reverse, it is something of a “sellers market”. Whether such performance will outweigh the willingness to diligently conform to the Code remains to be seen. It may also be a factor mitigating against the cross-border flow on effect of the code to jurisdictions outside of the U.K., notwithstanding take-up by industry leaders in the U.K.

### **Stock Lending**

One very important issue raised in the Consultation Paper is the potential impacts of stock lending by long-short managers and perhaps by event driven managers seeking to arbitrage merger and acquisition activity or in connection with “activism”.

ICGN has an articulated policy on stock lending and we attach a copy for your information. You will see that it is centered mainly on the responsibility of share owners who permit portions of their stock to be lent. As you are aware “lending” is a misnomer. The stock passes to different ownership, essentially for a rental payment, with the promise of it being replaced at the end of an agreed time.

ICGN has no in-principle objection to shorting stock as a legitimate means of achieving returns from stocks falling in favour in the market, as opposed those thought to be growing in favour. We do however oppose the borrowing of stock for voting purposes, noting that borrowers have every right to sell the “borrowed” stock to third parties who in turn acquire voting rights over the stock. The sale to third parties is an essential component of short selling, but there are dangers, especially when the economic holding is leveraged by the use of derivatives to produce voting power well beyond the actual economic interest in the subject company.

The mere fact that this can be done invites its use. Its misuse can distort voting outcomes resulting in “loaned” votes cast against the interests of the original stock lender – for example, where in some jurisdictions company takeovers can be achieved via a Scheme of Arrangement, inflated votes may be cast for or against the Scheme, or to fail to vote at all, preventing the achievement of the requisite majority, or the requisite number of shares voted, potentially frustrating the best interests of long term shareholders.

ICGN strongly supports the disclosure of derivative positions and the proposal that notification of “economic” interest be mandated.

### **Risk and Valuations**

We do not believe the issue should be focused on too much or too little risk but “what type of risk?” Investors will be familiar with equity risk, credit risk, duration risk and the like but may not understand the further types of risk involved in many hedge fund strategies such as liquidity, pricing, leverage etc. It might be said that “knowledge risk” is an obstacle to investors

considering hedge fund strategies. Investors should be able to understand the conditions under which their investment may suffer.

Quantitative analysis can be useful in helping investors understand risk. Information such as stress testing and scenario testing can provide investors with a more complete understanding of the types and levels of risk inherent in the relevant strategy.

In this regard, disclosure should cover the things which really impact on the strategies they are considering, including liquidity terms, internal and external leverage used and the other hedge fund specific issues outlined in the consultation paper.

Similarly, performance calculations and valuations should disclose the percentage of assets which are illiquid, not market priced and not listed.

### **Responses to the particular consultation questions.**

#### **1. Are there further issues the HFWG should address?**

In the area of disclosure, the HFWG might consider reporting on the continuing involvement of key personnel - since manager skill is a determinant of success – and manager alignment with investors by co-investment and/or reward.

Otherwise we believe the issues tackled are sufficiently comprehensive to found a code.

#### **2. Are there any comments/observations on the way in which we envisage conformity with the standards?**

As referred to above, ICGN regards “comply or explain” or “if not, why not” as an established transparency methodology in the U.K. and some other jurisdictions, and that using them in the launch of a new code is appropriate.

#### **3. What would be the best forum for disclosing conformity with the standards?**

We note that the standards would be under the stewardship of a Board of Trustees. The trustees could award a form of certification to Hedge Fund managers who submit to external verification by (say) an audit firm approved by the trustees, thus making the accreditation a sought after means of attracting investor funds.

(The caveat remains that accreditation is unlikely to displace superior performance.)

Standardising reporting, using the comply or explain formula, plain, non-legalistic language would enable investors to compare managers more easily.

The fora would thus include the annual report of the trustees and those of the hedge funds.

#### **4. Would improvements to visibility, as suggested be useful?**

- **What other areas of information related to the hedge fund industry would be of value?**
- **Would stakeholders see merit in firms which conform to the standards confirming this on their websites?**

We have answered the first and third questions in our previous comments above in the affirmative.

As to the second, ICGN supports the collation of industry data as proposed in section 5.3 of PART 1. With respect to individual managers, ICGN would support the publication by managers of the factual information suggested in 5.2 within the limits of the legislation.

#### **5. Questions relating to the proposed board of trustees, their mandate and composition.**

ICGN supports the proposal for a board of trustees to steward the Code of Practice Their mandate might include

- Engagement with the industry to promote conformity and its mutual benefit to managers and investors
- Reviews of take up
- An annual report
- Accreditation of conforming managers
- Reviews of the content of the Code from time to time
- Approval of independent auditors or others capable of signing off on conformity
- Commenting on hedge fund reports and disclosure privately to encourage best practice

#### **Funding**

It is not unusual for the subject industry in seeking to have its standards recognised to fund its own voluntary self-regulation. Subject to consideration of UK conditions we have no in-principle objection to other users of the code contributing to the work of the trustees.

#### **Composition**

We suggest that there might be merit in an independent chair and two or more investor representatives to ensure investor perspectives and concerns are taken into account and that

transparency and disclosure are provided in forms that are of genuine benefit to prospective investors.

**6. Questions relating to training and areas not covered in existing curricula (e.g. CAIA).**

The writer is not able to comment. It may be possible for an ICGN member, familiar with training available in the UK to offer advice on these matters at a later date.

Finally ICGN would like to signal to the Hedge Fund industry its willingness to meet with representative on a regular basis so that understanding of each other's positions can be deepened, which should prove mutually beneficial.

Should you wish to discuss or clarify any of these comments please do not hesitate to contact our Executive Director, Anne Simpson, by telephone on either + 44 20 7612 7098 or by email at [execdirector@icgn.org](mailto:execdirector@icgn.org).

Yours sincerely,

A handwritten signature in black ink, appearing to read "Michael O'Sullivan". The signature is fluid and cursive, with a long horizontal stroke at the end.

Michael O'Sullivan  
Chairman  
ICGN Shareholder Responsibilities Committee