

RESPONSIBLE INVESTMENT AND HEDGE FUNDS:

A DISCUSSION PAPER



THE PRINCIPLES FOR RESPONSIBLE INVESTMENT

The Principles for Responsible Investment were launched by the UN Secretary-General at the New York Stock Exchange in April 2006. The Preamble to the Principles states:

'As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society.'

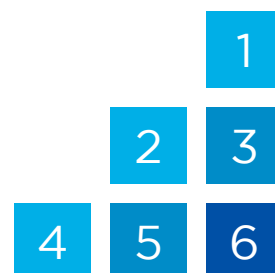
The PRI's Mission Statement – agreed by the Advisory Council in March 2012 is:

We believe that a sustainable global financial system that is efficient in economic terms is a necessity for long-term value creation, rewards long-term responsible investment and benefits the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration for their implementation; fostering good governance, integrity and accountability; and addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

THE SIX PRINCIPLES THEMSELVES ARE:

- 1 We will incorporate ESG issues into investment analysis and decision-making processes.
- 2 We will be active owners and incorporate ESG issues into our ownership policies and practices.
- 3 We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- 4 We will promote acceptance and implementation of the Principles within the investment industry.
- 5 We will work together to enhance our effectiveness in implementing the Principles.
- 6 We will each report on our activities and progress towards implementing the Principles.



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FOREWORD

By Katie Beith,
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Hedge funds are in the spotlight. Their supporters argue that they offer long term outperformance and strong diversification. Since the financial crisis their detractors have called this into question, and some policymakers have suggested that particular hedge fund instruments and strategies contributed to the general market turmoil.

A report by KPMG, AIMA and the Centre for Hedge Fund Research, Imperial College London, finds that during the period of 1994 to 2011, 'hedge funds outperformed traditional asset classes (such as bonds and equities) and did so with low levels of volatility – a finding that proved true even in difficult economic times.' It also concludes that 'the hedge fund industry continues to play a vital role in global financial markets, providing liquidity and having an overall positive impact on a wide range of factors, including price discovery, financial stability, portfolio diversification and more.' Two recently published books reach diametrically opposed conclusions about hedge fund performance so the debate will continue for some time.²

Hedge funds are important for PRI signatories. The initiative has a growing number of new signatories with exposure to hedge fund investments, and an increasing number of current signatories are growing their hedge fund allocations. According to the PRI's 2011 Reporting & Assessment survey, 137 PRI signatories have some exposure to investments in hedge funds (74 asset owners and 63 investment managers). Hedge Fund Research Indices (HFRI) estimates that hedge funds are a US\$2.1 trillion industry,³ and according to the GlobeOp Index, growing at 15 per cent per year.⁴ The PRI Secretariat therefore believes this paper is both timely and important.

On signing the PRI, signatories agree to implement the six principles across all assets under management. The Principles are aspirational in nature and their importance to the traditional asset classes, such as listed equity, is clear. However, recent years have seen growing appetite to understand how responsible investment relates to alternative investment strategies and instruments, including hedge funds, physical and derivative commodity investments and structured products. These are areas that are sometimes complex to understand from an investment perspective. In some cases it may not be clear how ESG issues, or the broader notion of responsible investment, are relevant to these types of investment.

This paper seeks to shed some light on these issues. In addition to exploring the applicability of ESG analysis and data to fundamental security selection in the hedge fund context, it highlights areas where particular hedge fund instruments and strategies may raise questions concerning risks for the individual fund or the market more broadly. Shorting, leverage, high frequency trading and the use of derivatives have all been subject to challenge in this respect in recent times.

Cutting across all these dimensions is the crucial question of hedge fund governance. Just as in the familiar listed equity context, good governance is vital to the protection of investors' interests. This is currently an area of intense debate in the hedge fund industry. The paper identifies actions investors can take to improve the fund governance of hedge funds such as the incorporation of a governance assessment into due diligence processes to ensure that the interests of investors are effectively addressed and protected by the board and its directors. It also encourages investors to require as much transparency as necessary to enable prudent due diligence, risk analysis and monitoring of portfolios.

This paper accepts that hedge funds can be part of a diversified portfolio and, therefore, does not aim to reach definitive conclusions on what is 'right' or 'wrong', 'good' or 'bad' in areas such as shorting or leverage. However, we do hope the paper will stimulate debate among PRI signatories, and we intend to create opportunities for further reflection that will develop investors' understanding of these challenges in a way that enables them to reach their own conclusions on what is appropriate for them.

Over the coming year, we look forward to continuing debate in the industry on the issues raised here, and hope the paper will enable PRI signatories to extend their understanding of responsible investment to include their investments in hedge funds.

NEXT STEPS

The PRI Initiative is actively seeking feedback on this paper which is meant to form the basis of further discussions. We plan to facilitate debate on the key issues discussed in this paper in order to enable asset owners and hedge fund managers to reach their own judgment on the most appropriate approach. Please send all feedback and comments to:
implementation.support@unpri.org

1. The value of the hedge fund industry to investors, markets, and the broader economy. KPMG and AIMA, April 2012

2. The success of hedge funds – Masterclass: Two books analyse what makes hedge-fund managers great—and reach very different conclusions. The Economist, 7 July 2012 - <http://www.economist.com/node/21558231>

3. Source: https://www.hedgefundresearch.com/pdf/pr_20120719.pdf

4. Source: http://www.globeopindex.com/capital_movements.go

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EXECUTIVE SUMMARY

Many PRI asset owner signatories have significant allocations to hedge funds, and PRI has a growing number of hedge fund manager signatories. Yet understanding of what 'responsible investment' in hedge funds means is still at an early stage of development. A number of recent high profile incidents relating to hedge funds, including a few serious frauds, have caused governance to be raised to the top of the list of concerns for hedge fund investors. The PRI Secretariat is also experiencing increasing demand from signatories to understand how to incorporate environmental, social and governance (ESG) information into hedge fund decision-making. To date, there is little consensus on the relevance of incorporating ESG information into hedge fund decisions, or how it may meaningfully apply to different hedge fund instruments and the widely divergent strategies that exist. This paper seeks to illuminate this debate and move it forward. The paper acknowledges that the flexibility of hedge funds can offer the benefit of absolute return and diversification. Yet in the extreme circumstances of the 2008 financial crisis and its aftermath, hedge fund performance has diverged widely by strategy, causing concern for some investors.

AN APPROACH FOR RESPONSIBLE INVESTMENT IN HEDGE FUNDS

This paper explores how to apply the concept of responsible investment to hedge funds. But before we look at the practical aspects, let's return to the reasons why signatories sign the PRI and take on the responsible investment agenda. The preamble to the six principles states:

"As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:" [followed by the six principles].

In March 2012 the PRI Advisory Council agreed a new Mission Statement:

"We believe that a sustainable global financial system that is efficient in economic terms is a necessity for long-term value creation, rewards long-term responsible investment and benefits the environment and society as a whole. The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration for their implementation; fostering good governance, integrity and accountability; and addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation."

Responsible investment describes an approach that aligns the long-term interests of asset owners and investment managers by integrating ESG factors into investment decisions and ownership activities. Experience in other asset classes shows that historically investors have not always recognised the financial significance of a range of factors that have for convenience come to be referred to as 'environmental, social and governance' issues. Research and practical experience shows that factoring these issues into investment decision-making and ongoing ownership activities can improve investment processes and outcomes.

Over and above this, in the aftermath of the financial crisis PRI signatories are increasingly aware of the importance of preserving the long-term health and efficient functioning of the market as a whole. Securing this broader objective is crucial for the fulfilment of asset owners' long-term fiduciary obligations.

Good governance of hedge funds themselves, and in the relationship between investment managers and asset owners, is crucial to this long-term alignment of interests.

This paper describes the characteristics of hedge funds and discusses the advantages and risks associated with the different techniques and instruments used within hedge fund investing. It talks about some actions hedge fund investors can take to improve the governance of hedge funds. It also highlights responsible investment practices that can be implemented within distinctive hedge fund strategies. It concludes by drawing attention to concrete actions that asset owners can take to

build relationships with their hedge fund managers in order to address responsible investment issues and challenges.

The following bullet points provide a summary of responsible investment practices that PRI signatories can apply to their hedge fund investments:

- Ensure robust governance of hedge funds and of the relationship between the investor and the hedge fund manager.
- Consider the relevance of ESG data to research before investment decisions are made - PRI Principle 1. This will be applicable in hedge fund strategies that involve fundamental analysis and security selection.
- Understand the concept of active and responsible ownership – PRI Principle 2 (first and foremost in the context of voting rights and engagement with corporate management). This will apply in strategies that involve holding long equity positions for a reasonable period of time. There are also factors to be taken into consideration in the context of borrowing and shorting stock, and in specific fixed income situations.
- Recognise the benefits and manage the risks for a hedge fund associated with the use of specific instruments and techniques – such as shorting, leverage, derivatives and high frequency trading.
- Identify the benefits and manage the risks that particular strategies might present for other parts of an investor's portfolio and for the market broadly.
- Maintain good stakeholder relationships by understanding and managing the issues that are of concern to particular stakeholders, such as state actors.
- Clear communication regarding your responsible investment expectations between asset owners and investment managers, culminating in a formal policy.

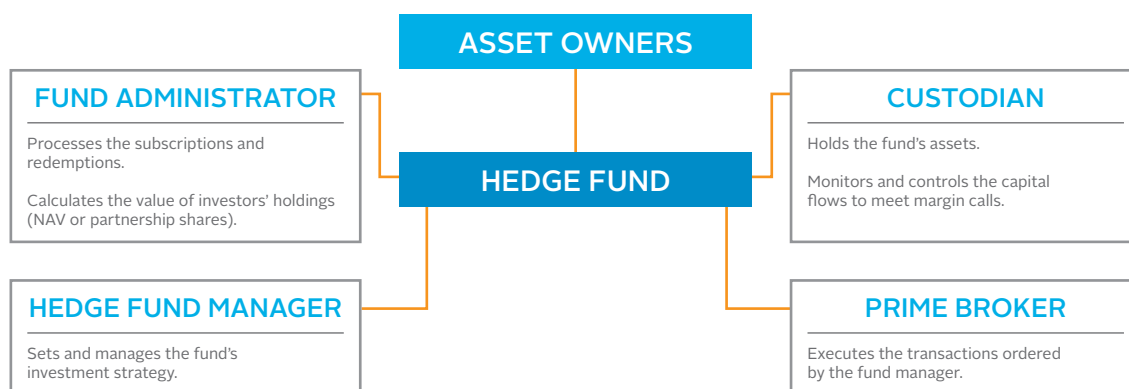
Specific actions that asset owners and hedge fund managers can take are set out in the sections on hedge fund instruments and strategies.

THE IMPLICATIONS OF HEDGE FUNDS FOR RESPONSIBLE INVESTORS

WHAT CONSTITUTES A HEDGE FUND?

There is no universally accepted definition of hedge funds. Each hedge fund is unique. Hedge funds are not an asset class but an investment vehicle or investment approach. Typically, they aim to generate an absolute (positive) return for their investors. To facilitate this, hedge funds' investment guidelines provide investment managers with a high level of freedom. Managers are not constrained by benchmarks, and have the discretion to use a wide range of techniques and instruments, including short selling, leverage, derivatives and high frequency trading.

Figure 1: Typical structure of a hedge fund offering



Source: AIMA

Hedge funds can invest in virtually any asset class. However, investments are predominantly in listed equities, sovereign fixed income, commodities, credit and currencies, through either cash instruments or by derivatives. Additionally, hedge funds can take a value or growth bias, a bottom-up or top-down focus, and/or a combination of these. The holding periods of hedge fund investments can vary from being short term in nature to long term.

A further consideration is that it is the individual hedge fund manager who decides on the legal structure of the hedge fund. Many hedge funds have been established offshore in order to attract international investors and benefit from tax advantages that may be available. Additionally, offshore locations enable implementation of complex and flexible investment strategies which regulated onshore funds prevent.

Hedge funds have become increasingly popular because of their potential for high returns and the diversification benefits they are often said to offer. However, the features described

above mean that their risk and return characteristics differ markedly from those of traditional long-only funds. They have in practice displayed wide variation in performance. During the financial crisis and the years following it some performed extremely well, while others have not been able to achieve their absolute return objectives.

The potential for absolute returns must therefore be weighed against the risks associated with investing in hedge funds. Given the flexible investment guidelines and the manager's discretion to use a range of tools and techniques, the success of a hedge fund relies very heavily on the individual manager's skill. Very high levels of due diligence are therefore required on the part of asset owners.

The responsible investment issues associated with hedge funds make the need for this thorough and careful approach all the greater. It is to these issues that we now turn.

HEDGE FUND GOVERNANCE

Due to a number of high profile incidents resulting from poor governance and a few serious frauds over recent years, governance has risen to the top of the list of concerns for many investors in relation to hedge funds. Behind some of the fund governance problems is the fact that the more flexible and less restrictive structures are often located offshore. It is estimated that c. 70 per cent of the industry is offshore.⁵ A report by the Hedge Funds Working Group which led to the establishment of the Hedge Funds Standard Board also identified the following three points as key reasons driving the need for appropriate governance mechanisms and oversight:

- Increasing remoteness between the ultimate investors and hedge funds;
- Increasing institutionalization, with investors looking for a higher degree of comfort; and
- Increasing 'retailisation' of the ultimate investor base, for example, the entry of retail investors, insurance companies and pension plans to the hedge fund market.

In the wake of the financial crisis, regulatory reform has been a focus of attention, and some offshore structures have come under scrutiny. Further, potential conflicts of interest can arise between the hedge fund manager and investors, but also between investors, for example in relation to manager remuneration, handling of redemptions, and other related factors. Given the entrepreneurial nature of all alternative investments and hedge funds in particular, there is an on-going debate about the right balance of regulation; the hedge fund industry has voiced concerns about potential overregulation. It is important that the interests of long-term investors are served by addressing these concerns while maintaining a hedge fund's ability to contribute to a diversified asset owner's portfolio.

The industry and regulators have made efforts to address these conflicts of interest and governance challenges. Both US and European legislative changes are underway. In addition, investors can seek guidance on best practice regarding hedge fund governance from Hedge Fund Standards Board (HFSB). The HFSB has published governance standards which are actively overseen by an independent board of trustees comprising hedge fund managers and investors. The HFSB works to promote transparency, integrity and good governance that reassures investors, facilitates investor due diligence and minimises the need for restrictive regulation. Another initiative to improve the governance of hedge funds is AIMA's Guide to Institutional Investors' Views and Preferences Regarding Hedge Fund Operational Infrastructures. Further, some asset owners are also encouraging regulators in offshore jurisdictions to raise governance standards.⁶

Regardless of the final outcome of the regulatory developments that are currently under way, and of the jurisdiction in which a hedge fund is registered, there are several steps investors can take to ensure high standards of fund governance. For example, a responsible investor may incorporate a governance assessment into their due diligence process to ensure that their interests as investors will be effectively addressed and protected by the board and its directors.

More specifically, two of the key governance issues that responsible investors can address are set out below.⁷

DIRECTORS

In the listed equity environment corporate governance codes covering matters such as directors' independence, skills and backgrounds, avoidance of conflicts of interest, length of tenure and the maximum number of board positions a director should hold are now widespread and generally accepted as being essential for the protection of investors' interests. In the hedge fund context, attention has only been directed to this area relatively recently.

According to a survey of 2315 Cayman Island domiciled funds carried out by Sound Fund Advisors in February 2012, 31 per cent of funds have no external directors. The most popular 'professional' directors sit on hundreds of boards, with the top 40 sitting on more than 100 each and the top 3 sitting on more than 500 apiece. This raises the question about how they can fulfill their obligations with so many commitments. The survey adds that c. 80 per cent of external board members work for professional directorship firms, fund services companies or law firms and do not, typically, have a background in investment. This raises questions about true independence, avoidance of conflicts of interests, technical competence, and practical availability to protect the interests of asset owners.

It should be noted that in the US, the general/limited partnership model is the most common structure for the pool of investment funds that make up a hedge fund. In this context, it is important to acknowledge that, in practice, governance approaches vary from jurisdiction to jurisdiction. This may be due to differing conventions or the use of fund structures, such as limited partnerships in the US, which are not naturally conducive to independent governing bodies. As a result, it is not always possible to achieve the degree of independence investors might consider necessary in order to mitigate conflicts of interest. In cases where no independent governing body is in place, the Hedge Fund Standards of the HFSB requires the fund documentation to contain more specific rules governing fund behaviour.⁸

5. Statistics quoted at the Agefi conference, April 4th, 2012

6. For example, 10 global institutional investors collaboratively write to the Cayman Islands regulator in January 2011 stating they would be very supportive of the creation of a fully functional and searchable on-line database which would provide investors with the requisite information on directors and service providers. This would facilitate more effective due diligence of potential hedge fund investments.

7. For further information, see Appendix IV: Universities Superannuation Scheme's (USS) responsible investment expectations for the governance of hedge funds.

8. See HFSB CP3: <http://www.hfsb.org/?page=11474>

Conclusion for responsible investors

As part of due diligence, investors can look into the background, role, contribution and oversight functions of the independent directors as well as the board's overall governance structure. A starting point would be to ensure good, competent and independent directors are appointed to the boards of hedge funds. Investors could expect a majority of independent directors with requisite skills-sets and experiences to be appointed to all boards including an independent chair.

TRANSPARENCY

In many hedge funds there is a lack of visibility of the underlying investments. This means that decisions about which hedge fund to invest in are based significantly on the nature of the fund's investment mandate, the hedge fund manager's track record, and the asset owner's assessment of the fund terms, conditions and governance. The increasing number of institutional investors investing in hedge funds is driving a demand for more transparency. Greater transparency is needed to help, amongst other things, alignment of interests between asset owners and investment managers. There are a number of initiatives currently under development, such as The Open Protocol (OP), aimed at standardising how hedge funds collect, collate and communicate risk exposure information. OP seeks to enable the availability of detailed risk information to investors in a form that they can aggregate with the rest of their portfolio. This is achieved through a conduit that allows the manager to keep individual positions private if that is considered appropriate.

Transparency is also essential on all fund terms – such as investment gates, lock-ups, liquidity levels, valuation, risk management and monitoring, etc.

Conclusion for responsible investors

Investors could require as much transparency as necessary to enable prudent due diligence, risk analysis and monitoring of portfolios. Investors could expect hedge fund managers to clearly and transparently disclose all details of the fund governance structure, including all fund terms and conditions. They can also support ongoing collaborative initiatives to foster greater transparency such as OP.

RESPONSIBLE INVESTMENT AND HEDGE FUND TECHNIQUES AND INSTRUMENTS

Hedge funds typically use one or more of the techniques and instruments set out below. It is important to understand the advantages and potential risks of each of these techniques.

SHORT SELLING

Short selling, or 'shorting', involves borrowing a financial instrument from a third party today, selling it in the market, and then buying it back at a later date to return it to the third party lender. Shorting is profitable if the instrument borrowed and sold depreciates in value, but a loss is incurred if the instrument appreciates in value.

Advantages

Efficiently and correctly applied, shorting allows investors to build portfolios combining long and short positions, thereby protecting (i.e. hedging) the portfolio from negative price movements and reducing portfolio exposure to overall market fluctuations. Shorting may also create alpha if overpriced securities are identified and shorted. The technique of shorting has been the cause of much debate and controversy. Supporters of shorting argue that it can accelerate price corrections in overvalued securities. It also supports derivative trading and underlying market liquidity.

Risks

Critics say that excessive short selling harms market confidence, exacerbates downturns and increases price volatility. Therefore, they argue that the practice should be curbed by strict regulations. In the wake of the financial crisis several countries have introduced temporary restrictions on short selling of stock in banks and other financial institutions.

Conclusion for responsible investors

Significant amounts of research by academics and regulators have been undertaken in the hope of reaching unbiased conclusions on the impacts of shorting.⁹ Broadly, this research has supported short selling as a legitimate activity that is an integral part of efficient and well-functioning markets. However, investors may seek to familiarise themselves with the technique of shorting and ensure that they understand the investment strategy of the manager with regard to shorting and potential market implications.

LEVERAGE

The flexibility allowed to hedge fund managers also enables them to use leverage. The dynamic use of leverage is a key ingredient in the execution of some hedge fund strategies. The degree of leverage used in hedge funds varies substantially. Leverage can be achieved in various ways and can take different forms. Financial/balance sheet leverage is the most visible and widely recognised form. This is just assets over and above the equity base, achieved in the main by borrowing. Economic

9. Bris, A., Goetzmann, W.N and Ning, Z. (2003). 'Efficiency and the bear: Short sales and markets around the world'. Working Paper 9466. National Bureau of Economic Research. Available: <http://www.nber.org/papers/w9466>

March, I.W. and Niemer, N. (2008) 'The Impact of Short Sales Restrictions'. A third party analysis commissioned and funded by the International Securities Lending Association (ISLA), the Alternative Investment Management Association (AIMA) and London Investment Banking Association (LIBA).

Lobanova, O., Hamid, S.S and Prakash A. J. (2010). 'The Impact of Short-Sale Restrictions on Volatility, Liquidity, and Market Efficiency: the Evidence from the Short-Sale Ban in the U.S.' <http://ssrn.com/abstract=1571601>

leverage refers to an embedded leverage that may not show up on the balance sheet. For example an option has “built-in” leverage because when the stock goes up or down the value of the option is magnified. Leverage is also created in shorting as the hedge fund sells an asset it does not own. A hedge fund strategy focusing on market dislocations, such as the relative mispricing between two securities, can include leverage. However, it can also be substantially less risky than the leverage deployed in a directional hedge fund strategy.¹⁰

Advantages

Leverage can enhance expected returns. It also constitutes a risk management technique by enabling calibration of the risk return profile of the portfolio in line with investor risk appetite.

Risks

Where leverage is excessive or not properly managed and controlled, it can result in undue risk taking and the destabilising of investments. In times of market stress or illiquidity, excessive leverage across a large number of investment managers and financial institutions could harm the economy as a whole. Stability of the provision of leverage is also a concern as some banks were able to pull leverage credit lines extended to hedge funds during the financial crisis, further exacerbating the effects of the market moves.

This is an area for further research, particularly as hedge funds were publicly accused of contributing to the global financial crisis. From an academic and industry research perspective, there is little evidence to support this, suggesting that the debate needs to evolve. For example, a recent UK Financial Services Authority survey stated that risk to financial stability through the hedge fund market channel is limited.¹¹ Other research by the Alternative Investment Management Association (AIMA) concludes that it appears unlikely that individual hedge funds could create a systemic event through synchronised actions or reactions, since the universe of hedge funds is so diverse and full of competing and contrarian strategies.¹² However, further research and understanding of all aspects of systemic risk are needed.

Conclusion for responsible investors

It is important that asset owners are aware of the possible implications of leverage used by hedge fund managers.

Investors may seek to ensure before investing that they understand how leverage will be used in the fund, maximum leverage levels the fund proposes to use, and the implications for their investment in various market scenarios. The key metric for the most investors will be the difference between the amount of capital invested and the amount that could be

lost. Investors could satisfy themselves that managers have procedures in place to accurately evaluate, monitor and limit economic leverage, financial leverage, derivative exposure and counterparty risk (which is inherent in many forms of leverage).

Investors could also ensure that they understand the implications of failure to manage leverage across the market as a whole, and the relationship between their own investment and this broader concern.

DERIVATIVES

Many hedge fund strategies use derivative instruments, such as forwards, futures, swaps and options. Derivatives can be traded via exchanges or bilaterally over the counter (OTC). Derivatives are normally cleared by independent market clearing houses, which require hedge funds to post collateral as margin for fluctuations in the value of the derivatives. This means that trading derivatives also entails the need for collateral management. Margins required for trading futures are also a means for hedge funds to apply leverage to their portfolio. However, the degree of a suitable margin to equity ratio varies for each hedge fund. Investors may take a view on transacting via derivatives, and especially credit default swaps, due to settlement issues in the OTC market and the associated higher risk of default. A manager should be able to explain their counterparty risk management process on OTC products. Investors may seek to identify the hedge fund manager's main use of derivatives (whether for substitution, risk control/hedging or arbitrage), the anticipated economic leverage involved in the derivative exposure, as well as how derivatives will be valued and monitored and the estimated maximum potential loss as a result of leverage.

It should be noted that trading in OTC derivatives is regulated in the US, by the Dodd-Frank Act and in Europe, by the European Market Infrastructures Regulation (EMIR). Though there are a number of important differences between the regulations, both seek to mitigate systemic risk and increase transparency. In parallel, other active and planned regulations are forcing institutional investors to be more risk-conscious when using OTC derivatives.¹³

Advantages

Using derivatives allows a manager to manage and hedge risk in the fund, thereby potentially enhancing risk-adjusted returns. Additionally it can allow for instruments to be traded more efficiently and in a more liquid form than the underlying reference security.

10. 'Directional' refers to a strategy's opening positions, either long or short, on the belief that the investor is able to correctly predict the movement of price in a security, i.e. if the investor thinks a security is going up, they buy).

11. Financial Services Authority (July 2011). 'Assessing the possible sources of systemic risk from hedge funds: A Report on the findings of the Hedge Fund Survey and Hedge Fund as Counterparty Survey'. Available: http://www.fsa.gov.uk/pubs/other/hedge_fund_report_july2011.pdf

12. AIMA Journal Q2 2011

13. For example, Europe's undertakings for collective investment in transferable securities (Ucits) directive and Solvency II frameworks. There are indications that electronic execution and clearing will soon be obligatory, in conjunction with a requirement to mark derivatives to market on a daily basis.

Risks

Derivatives can be used to speculate, making small bets that have large payoffs or losses. There is often counterparty risk, which needs to be monitored in a portfolio context. This is especially true for OTC derivatives, where exchanges are not involved and it is not always clear which parties have exposure to each other.

In extreme situations hedge funds may be required to post additional collateral to support derivatives exposure. Derivatives may generate losses that exceed capital invested, which is a key concern for some regulators. However, in general, the limited liability of fund structures limits the liability of investors to the amount of capital committed to a hedge fund.

Conclusion for responsible investors

Asset owners may seek to ensure that they fully understand the implications of a fund's use of derivatives, including the counterparty and other risks that might arise in extreme situations. They may also seek to ensure that managers have adequate procedures to mitigate and manage these risks. Investors may want to be aware of and understand the impacts of regulatory initiatives that will likely change the OTC derivatives industry.

HIGH FREQUENCY TRADING

Many hedge fund strategies employ very active trading in order to exploit short-term mispricings in the market.

Advantages

Very active trading can allow hedge funds to exploit very short-term opportunities arising in markets. This active trading can contribute to providing liquidity to markets.

Risks

Critics argue that high-frequency trading (HFT) front runs the market, creating an unfair advantage over long-term investors. HFT has been accused of destabilising markets, increasing volatility and providing only a 'mirage of liquidity'.¹⁴

Conclusion for responsible investors

Hedge funds account for only a relatively small proportion of total HFT in the market.¹⁵ Nonetheless, this may still be a concern that investors wish to consider. Asset owners may seek to ensure that they understand the implications of the trading strategies used by hedge funds, both for the fund itself and for the market more broadly and their portfolio as a whole.

RESPONSIBLE INVESTMENT AND HEDGE FUND STRATEGIES

The challenges arising from the governance of hedge funds and the various hedge fund techniques and instruments described above create a need for investors in hedge funds to take particular care in assessing and understanding the implications of their investment choices. This part of the paper looks at the integration of ESG issues within different hedge fund strategies. This paper does not go into the roles played by thematic hedge funds which focus on sustainability solutions. This is deliberate. While we recognise that these types of funds are an important part of the responsible investment agenda, we have identified a clear need to raise the debate around the relevance of ESG integration in different hedge fund strategies and fund governance.

Integrating ESG factors in hedge fund investing is only now emerging as a practice and many hedge fund managers may not have previously contemplated formal or explicit ESG integration. This may be due in part to the fact that classification of hedge fund strategies is a formidable exercise, and it may not be immediately apparent how ESG issues are relevant to some of those strategies. Further complicating the matter is that categorisation of hedge funds differs among industry bodies and each manager may have a unique strategy and trading style.

However, while hedge funds may be diverse with complicated drivers of risk and return and use techniques such as short selling or derivative instruments, there are many opportunities for investors to evaluate the ESG risks and opportunities associated with a hedge fund manager's strategy. This can be done by breaking the overall strategy into components and focusing on the drivers of risk and return. Responsible investment practices that apply to traditional asset classes (equities, credit, and private equity) can then be applied to understand the impact of ESG factors to a hedge fund investment.

In considering hedge fund instruments we focus essentially on levels of risk generated either for the fund itself or for the market more broadly and by extension potentially for an asset owner's whole portfolio. Applying the overall framework set out earlier, here we focus in particular on:

- the relevance of ESG data to research before investment decisions are made (PRI Principle 1)
- the concept of active and responsible ownership (first and foremost in the context of voting rights and engagement with corporate management – PRI Principle 2)
- understanding and managing the risks that particular strategies might present for the market as a whole and

14. E.g. Creating a Socially Useful Financial System, Andrew Haldane, Executive Director for Financial Stability, Bank of England. Presentation at Institute for New Economic Thinking conference, April 2012 - <http://ineteconomics.org/conference/berlin/andrew-haldane-creating-socially-useful-financial-system-25>

15. 6%, according to research by TABB Group, cited in High Frequency Trading – How the Market Developed and Where it is Headed – Stuart Baden Powell, Head of European Electronic Trading Strategy, RBC Capital Markets Europe. <http://www.thehedgefundjournal.com/magazine/201109/commentary/high-frequency-trading.php>

therefore for other parts of an investor's portfolio

- issues that are of particular concern to an individual investor for other reasons, such as the need to maintain good relationships with particular stakeholders

*What follows is neither prescriptive nor a fully exhaustive analysis of hedge fund strategies. Rather, the aim is to stimulate thinking about activities investors can undertake.

FUNDAMENTAL SELECTION, EQUITY OR CREDIT LONG/SHORT

Incorporation of ESG factors into a hedge fund manager's investment processes may be a key priority for investors in strategies that employ a security selection process that allows the manager to explicitly weigh and consider fundamental factors. Such an approach could be suitable in an equity or credit long/short strategy. However where a strategy involves being long or short an index or sector (as opposed to an individual equity or credit) investors may determine that application of specific ESG factors may not be practical. Many of the issues investors face when considering fundamental selection hedge fund strategies versus systematic trading strategies are similar to those faced by investors in passive pooled funds.¹⁶

Voting and engagement activities may also be appropriate in equity and credit long/short strategies. A hedge fund manager who maintains significant holdings in an investee company over a medium and longer term period could be expected to have and implement a voting and engagement policy which address ESG issues in both equities and fixed income, as applicable. Investors should seek to restrict the activity of borrowing shares for the purpose of voting. Failure to monitor this area effectively could result in an asset owner voting in different ways on important issues at companies held in different parts of its portfolio (e.g. in a long-only equity mandate vs. an equity long/short hedge fund). De-coupling economic interests from voting rights undermines the foundation and efficiency of the current system of corporate governance. This position is in accordance with the International Corporate Governance Network (ICGN) Global Corporate Governance Principles and the standards promoted by the Hedge Fund Standards Board (HFSB). Voting of borrowed stock would be acceptable only upon specific instructions from the lender of the borrowed shares. This activity would typically occur in activist strategies.

As noted in the section on hedge fund instruments, shorting may also give rise to concerns regarding the impact on individual companies or the market at large. Some investors may therefore want to consider avoiding strategies that involve large directional bets on a stock's decline or naked shorting (shorting without borrowing the stock that is being sold).

Conclusion for responsible investors

When a hedge fund manager engages in a fundamental analysis and selection process, ESG risks and opportunities can and should be identified as an integral part of the analysis and then appropriately weighed and managed. Emerging markets may have less developed legal and regulatory protections relating to the management of ESG issues and therefore warrant a higher degree of attention. Investors may want to ensure that managers whose strategies include fundamental selection in emerging markets support or endorse international standards for governance, transparency and regulatory improvements. See Appendix II for a selection of relevant ESG standards and codes.

Investment managers who hold significant long equity positions for reasonable amounts of time could have voting policies and might be expected to conduct engagement with corporate management.

Investors could seek to restrict the activity of borrowing shares for the purpose of voting. Some investors may wish to avoid strategies that include large directional bets on a stock's decline, or naked shorting.

RELATIVE VALUE (RV), ARBITRAGE AND VOLATILITY STRATEGIES

An investor may determine that considering ESG factors may be less relevant when securities are bought or sold with minimal or no regard to fundamental analysis or the nature of the underlying business. This may be especially relevant when trades are made using computerised quantitative models or when there is little or no impact on the cost of capital for the underlying companies. Examples of hedge fund strategies when this may be the case include statistical arbitrage (e.g. smoothing short term supply/demand disruptions); capital structure arbitrage (e.g. simultaneously buying and selling different parts of a company's capital structure); volatility arbitrage (trading volatility); basis trades (e.g. simultaneously buying and selling of the same risk via the physical and derivative instruments); market making; convertible arbitrage; corporate credit arbitrage and relative value strategies in structured securities backed by mortgages; consumer credit; or other collateralised debt; and fixed income relative value. In these situations, investors may seek to consider the wider market considerations of the strategy.

However, with the growing provision of ESG data, instances of quant managers using ESG data in sophisticated optimisation strategies are emerging. Some of these emerging approaches may prove to be valuable in some of the hedge fund strategies discussion in this section.

Conclusion for responsible investors

Asset owners may seek to ensure that they fully understand the types of information hedge fund manager's use in relative value, arbitrage and volatility strategies, and

¹⁶. PRI has published a compendium of case studies which provides examples of how investors invested in passive management strategies are implementing their RI programmes

whether they have explored the potential for ESG data to add value. Investment managers are encouraged to undertake research of this kind. If high frequency trading strategies are used, asset owners could also ensure that they understand the implications on the fund itself and for the market more broadly and their portfolio as a whole.

EVENT DRIVEN, CORPORATE DISTRESSED, BANKRUPTCY, RESTRUCTURING

Investors in event-driven strategies are likely to recognise that mergers and acquisitions are a normal part of business life and equity markets. However, strategies that take no account of the long-term value of takeovers to investors may cause concern.

Distressed investing often deserves a higher degree of ESG attention because of attendant social and governance issues. This may be less of a concern where investment is made in businesses which are in default, bankruptcy or financial difficulties with a view to restructuring them or turning them around. Operational restructurings (as distinct from financial restructurings), which involve job losses, may be a particular area of focus for many investors if social risk is not adequately managed. Other areas of concern may be bankruptcy or restructuring strategies, and companies operating in residential foreclosures.

Conclusion for responsible investors

Investors may want to ensure that no form of improper pressure or coercion is applied by the hedge fund manager in distressed investing situations, including seeking to claim shareholder rights through positions in derivatives, and in strategies involving residential foreclosure.

GLOBAL MACRO, MULTI-STRATEGY AND GLOBAL TACTICAL ASSET ALLOCATION (GTAA)

Global macro, multi-strategy and GTAA strategies will probably include components of many of the other strategies described in this section. For example, the use of equity/credit indices within a global macro strategy means that an investor may need to include all the considerations on fundamental selection for equities and credit long-short listed above. Global macro strategies will involve a detailed assessment of the ESG risks a country faces along with assessment of other risks, such as currency exchange risks, in addition to security-level issues in foreign markets (such as custody risks, settlement risks, risks related to capital controls – for instance repatriation issues and FX-restrictions - and tax risks). Further, investors should be

mindful that the use of derivatives for leverage is common.

Conclusion for responsible investors

The use of ESG data may be relevant in the composition of equity and credit indices and in country risk analysis in macro strategies.

When a manager uses multiple strategies, investors could focus on the main strategy (strategies) and apply relevant responsible investment practices as appropriate.

FOREIGN EXCHANGE

Strategies involving large, directional, foreign exchange trades may concern investors. In extremes such trades may destabilise markets to an extent that is detrimental to investors' financial interests across their portfolio. They may also be controversial with stakeholders, such as state actors, that are important to individual asset owners.

Conclusion for responsible investors

Investors may wish to develop a policy to conduct enhanced due diligence if it is believed that a strategy which takes positions in currencies (or sovereign debt) has the potential to affect the fortunes of an economy at a time of vulnerability if the strategy is widely pursued by a range of managers.

FIXED INCOME: GOVERNMENT AND SUPRANATIONAL DEBT

Some investors may wish to consider country-specific issues and in particular the social risks arising from exposure to debt of countries with oppressive regimes and human rights abuses. Some investors may have concerns relating to the perceived 'exploitation' of developing countries.

Conclusion for responsible investors

Some investors may wish to discuss sovereign bond restrictions with a hedge fund manager, preventing investments in the bonds of a country subject to, for example, UN Security Council sanctions. Some investors may want to avoid strategies which could be seen as exploiting the sovereign debt of developing countries.

For more information on responsible investment in sovereign fixed income, please visit the [PRI Signatory Extranet](#).

MORTGAGES, ASSET BACKED SECURITIES, SPECIALISED CREDIT AND FINANCIAL SERVICES STRATEGIES

An investor may have concerns around the accessibility of loans, servicing and collection practices, and the collateralisation of those loans. Issuer conflict of interest may be a focus of concern in relation to asset-backed securities/commercial mortgage-backed securities and other structured asset backed derivatives. Traded life strategies (in which an individual sells their life insurance policy and receives a payment that is less than the death benefit, but exceeds the cash surrender value) may be useful to some individual sellers but could also be of concern to some investors.

Conclusion for responsible investors

Investors may wish to ensure that managers who actively participate in servicing and collection strategies in personal or mortgage debt comply with fair lending laws. They may also want to seek some assurance from hedge fund managers about their relationship and agreements with third parties providing these servicing and collection services.

Investors may seek full disclosure from the fund manager in relation to all parties involved in structuring securities, and on any position the issuer has itself taken in relation to the securities.

Some investors may wish to avoid traded life strategies.

COMMODITY STRATEGIES

Commodity markets are characterized by “natural hedgers” such as producers off-setting production risk (for example corn prices) and users off-setting input costs (for example manufacturers using copper) and “speculators” (market participants interested in commodities for purely financial reasons). Speculators help to provide liquidity for the hedgers. It has been argued that speculative trading, if pursued aggressively, may entail negative economic or social impacts in particular countries. These may have financial impacts on other parts of an investor’s portfolio, or give rise to other concerns (such as the impact on relations with stakeholders, for example, state actors, who are important for a particular investor). It should be noted that situations where a single investor can have a high market impact are very rare and are generally confined to the smallest commodity markets.

Conclusion for responsible investors

The commodities asset class is fundamentally linked with ESG issues. However, the ESG issues that need to be considered vary depending on the type of investment. Investors could have an understanding of the ESG issues involved with exposure to commodities through real productive assets, debt or equity investments, physical commodities (direct or indirect) or commodity derivatives. Investors may want to understand if and how physical and derivatives investments can impact the functioning of markets and the sustainable development of economies.

For more guidance on responsible investment in commodities, please see the recent onValues, PRI and United Nations Global Compact report, [‘The Responsible Investors Guide to Commodities: An overview of best practices across commodity-exposed asset classes’](#).

PRIVATE EQUITY

Hedge funds can and do invest in private equity. While ownership structures and governance differ between public and private equity, the underlying asset in which they invest is the same – a company. The information and analysis needed to identify and manage material ESG risks and opportunities is the same in public and private equity. The PRI has published a number of private equity resources which may serve as a guide for these strategies. These resources can be accessed on the on the PRI Signatory Extranet, on the [Private Equity work stream page](#).

THE RELATIONSHIP BETWEEN THE ASSET OWNER AND THE HEDGE FUND INVESTMENT MANAGER

To address the responsible investment issues and challenges arising in the context of hedge fund governance, instruments and strategies that we have outlined thus far, an appropriate relationship needs to be established between the investor and the investment manager. Open communication of expectations and of what is possible is required. Clear and formal agreements are needed to provide a structure that guides and supports the delivery of responsible investment objectives. It is key to ensure, as a first step, that hedge fund managers are aware of the impact of ESG issues on different strategies and also of their importance, both in terms of investors' needs as well as risk management and value creation.

ESTABLISH AGREEMENT ON WHAT RESPONSIBLE INVESTMENT MEANS

EXPLAIN WHY RESPONSIBLE INVESTMENT PRACTICES ARE IMPORTANT FOR YOUR PORTFOLIO

Asset owners have different perspectives on responsible investment and therefore different motivations for asking about ESG-related risks and opportunities. Their motivations can range from a more ethical approach with an emphasis on the wider market to a singular focus on value creation and risk.

Investors will need to understand and assess the risks associated with the particular hedge fund strategy in which they want to invest. This assessment will need to take account of both financial factors linked directly to the fund itself and to potential wider impacts on the market, and of other considerations that are important to the investor (such as relations with important stakeholders). Some investors may wish to avoid particular individual investments or strategies, or they may seek restrictions on the use of certain instruments and techniques.

A hedge fund manager is unlikely to understand the rationale behind an investor's responsible investment interests unless 'what' is being requested is put in the context of 'why' the investor believes it to be in their interests. Investors could therefore communicate their interests, motivations and situation to a hedge fund manager to provide context to their expectations. This may include explaining the investor's investment beliefs, the governance of the fund and the part played by particular stakeholders, the investor's responsible investment policies, etc.

COMMUNICATE YOUR SPECIFIC EXPECTATIONS BEFORE INVESTMENT

A hedge fund investor could clarify its expectations for responsible investment practices before investment, because it normally would be considerably more difficult to address any

concerns after an investment has been made. Unlike in a public company setting where buying a share gives you the right to engage with the company to influence changes post-investment, in the context of collective investment vehicles, an investor typically has far less opportunity to influence the manager after the investment has been made. Equally, while a public company cannot stop an investor from buying or selling shares, some hedge funds are closed funds and the manager can decide who has access to the funds, and some divestment conditions may also apply. The relationship between the hedge fund investor and manager is generally dictated by the legal terms in the investment agreement, with fewer market rules and regulation.

There are certain strategies where a RI policy or specific requests could be extremely important (and a failure to successfully reach agreement on the subject could preclude investment). There are other situations where a policy or request might be a 'nice to have'. An investor's degree of influence and negotiating leverage regarding responsible investment practices will vary depending on, among other considerations: the size of an investment; the history and size of the manager; and whether an investment is made via a separately managed fund or a co-mingled fund. As with any asset class, influence is likely to be more effectively applied through collaborative action by investors. In addition investors need not presume that legal impediments prevent them from working together in their discussions with a hedge fund manager on ESG issues either before or after the investment, although this may vary by jurisdiction.

ASSESS THE MANAGER'S ABILITY TO MEET YOUR REQUIREMENTS

Investors will need to assess a manager's ability to adequately integrate ESG factors at the security selection level, and to monitor and manage wider responsible investment issues such as the impact of hedge fund instruments and strategies on the market more broadly. This may be demonstrated through its policies, systems, and/or relevant expertise. Currently, however, there are very few hedge fund managers with a policy that includes wording to drive the implementation of a responsible investment programme or the incorporation of ESG issues into investment decisions. Sample responsible investment commitments for a hedge fund manager can be found in Appendix IV.

As part of the due diligence process, some investors may want to discuss whether and how ESG-related risks and opportunities are assessed and managed by an investment manager. Others may find it useful to discuss examples of how past trades have been made or avoided (or would be evaluated) based on ESG-related risks and opportunities. Investors may also want to assess whether their own RI policy is compatible with the hedge fund manager's approach and strategy, and confirm the ESG-related disclosures that a manager will provide.

Combined with a manager's demonstrated ESG integration, general responsiveness to an investor's requests for a RI policy or specific ESG requests may provide a basic framework for an investor to judge whether a hedge fund manager takes ESG risks seriously.

Investors can establish the governance framework once expectations have been clarified and the manager's ability to satisfy them has been established. The formal governance framework for the agreement needs to be put in place in a way that incorporates the agreed ESG and responsible investment matters.

Investors can consider both the mechanism to implement the ESG-related requests and the level of legal rigor that these requests require. The following list provides some suggestions to ensure meaningful practices are implemented. Please note that the following list is not exhaustive.

USE FORMAL MECHANISMS TO IMPLEMENT ESG REQUESTS

A manager's commitments could be documented in:

- a side letter;
- the investment restrictions section of a manager's limited partnership agreement or shareholder agreement; and
- an ESG/RI policy, including voting and engagement strategies where appropriate.

These may be difficult to implement for smaller investors or investors in pooled funds.

ENSURE A SUFFICIENT LEVEL OF LEGAL RIGOUR AROUND YOUR RESPONSIBLE INVESTMENT REQUESTS

The main implementation levels are:

- binding contractual commitments, with penalties for breaches;
- a formal responsible investment policy that is treated like all other policies, such as the manager's code of ethics, with defined consequences for breach; and
- non-contractual commitments.

Additional guidance can be found in the AIMA paper, 'Guide to Institutional Investors' Views and Preferences Regarding Hedge Fund Operational Infrastructures'.¹⁷

ENSURE AN AGREED RESPONSIBLE INVESTMENT POLICY

Where a manager drafts a RI policy as part of an investor's requirements, the investor needs to consider whether that policy needs to be approved by themselves and what happens when there is disagreement over the quality or content of the policy. The investor may also consider requiring that a manager commits to abide by its own currently published responsible investment policy, as there may be no link between such a policy document and the manager's contractual commitments.

ENSURE CAPACITY TO MONITOR AND REPORT

After investing in a fund, investors may seek to continually review and monitor an investment to assess whether a manager's policies, systems and processes are being applied effectively and continually improved. Investors could ensure that the manager is able to meet their monitoring and reporting requirements. A broad range of processes for notification exist within current communication channels. For example ESG requirements can be added into fund terms. One relatively simple mechanism, for example, could be that the investor requires a manager to send a letter annually that the manager is in compliance with its own responsible investment policy.

ENSURE THE CONSEQUENCES OF A BREACH ARE UNDERSTOOD

Investors need to also consider their position on the consequences of a breach of the ESG policy or reporting requirements. This will often require a practical assessment of the costs to all parties. Overly burdensome consequences for minor breaches need to be considered in the overall context of the investor's liquidity. When an investor has frequent or strong redemption rights, they may contemplate leaving the fund when the manager is in material breach of an ESG requirement.

17. AIMA ISC (May 2011). 'Guide to Institutional Investors' Views and Preferences Regarding Hedge Fund Operational Infrastructures'. Available: <http://www.aima.org/en/document-summary/index.cfm/docid/CF822EF3-CB7A-4B13-81A7949E4C97CoAA>

THE WAY FORWARD: CHALLENGING QUESTIONS FOR THE INDUSTRY TO TACKLE

This discussion paper seeks to raise awareness about actions that responsible investors can take when investing in hedge funds and to challenge investors to think about their role in managing some of the risks associated with the hedge fund industry. There are still many unexplored issues on which we hope to provoke debate and research in the coming months. These areas include:

- What is the value of ESG data in fundamental hedge fund strategies?
- How can investors better assess risks associated with particular hedge fund instruments and strategies and seek their mitigation?
- What are the appropriate governance standards for hedge funds?
- How do particular hedge fund strategies interact with other parts of the portfolios of diversified asset owners with investments across a broad cross-section of the market?
- How can signatories collectively apply the six PRI Principles to bring further developments for RI in the hedge fund context?
- What is the fiduciary duty of a hedge fund manager and how can this be aligned with the fiduciary duty of the asset owner?

This paper is a work in progress and will develop over time as the PRI Hedge Fund Work Stream matures. We invite PRI signatories and other members of the investment industry to consider whether any of the challenges mentioned in this paper should be prioritised as areas of focus for the work stream.

PREPARATION OF THIS DOCUMENT

This document was prepared by the PRI Hedge Funds Working Group and the PRI Secretariat. The recommendations and suggestions it contains are those of the representatives of the Working Group and the Secretariat. They should not be interpreted as representing the views of individual PRI signatories or the PRI initiative as a whole. The PRI Secretariat would like to thank all working group members for the significant contributions to this document.

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APPENDIX I: THE SCOPE OF ESG AND RESPONSIBLE INVESTMENT

There is no comprehensive list or method for categorising ESG issues. This section contains a list of issues investors refer to under the heading of 'ESG'. It is not comprehensive and should not be used in a way that restricts the scope of issues that investors may choose to consider. While some investors may define their own priority ESG issues based on industry sector or geography, the concept of responsible investment implicitly seeks to expand the scope of issues considered in investment decisions.

Stability and health of the market

Environment

- Climate change
- Environmental policy
- Sustainability best practice
- Environmental management
- Water supply
- Sustainable transport
- Waste

Social

- Consumer rights
- Supply chain management
- Health and safety
- Product safety
- Labour relations, inc. relationship with unions
- Community/ stake holder relations

Governance

Companies

- Board structure
- Independent directors
- Chairman/ CEO split
- Exec. pay
- Shareowner rights
- Accounting/ audit
- Business ethics
- Conflicts of interest

Funds

- Fund governance
- Advisory committee powers and composition
- Valuation issues
- Free structures

Source: PRI

The failure to identify and manage adequately ESG issues may give rise to a range of different strategic, operational and reputational risks and opportunities. Only in some instances may these risks and opportunities be material. While the assessment of materiality is often subjective, many investors expect the analysis to be undertaken in a formal process and based on tangible data. Other examples of ESG lists can be found at:

- CFA Institute publication Environmental, Social and Governance Factors at Listed Companies: A Manual for Investors
- ISO 26000 (draft standard) Guidance on social responsibility
- Global Reporting Initiative (GRI) Sustainability Reporting Guidelines. GRI has also produced a series of Sector Supplements, which offer more specific guidance on the following industry sectors: Electric utilities, logistics and transportation, mining and metals, tour operators, telecommunications and automotive
- The UN Environment Programme's Industry Report Cards on Environmental and Social Responsibility, which were developed in collaboration with over 45 international business and industry associations.

Over and above individual ESG issues, the stability and functioning of the market as a whole are an increasing focus of concern for asset owners, particularly the largest and most highly diversified.

APPENDIX II: ESG CODES AND STANDARDS

When developing an approach to responsible investment in hedge funds, an investor can draw on a broad range of other sources, including:

HEDGE FUND-SPECIFIC GUIDANCE DOCUMENTS

- PWG: Best Practices for the Hedge Fund Industry www.treas.gov
- HFSB: Hedge Fund Standards: Final Report www.hfsb.org
- AIMA: Road map to hedge funds www.aima.org
- MFA: Model Due Diligence Questionnaire for Hedge Fund Investors www.managedfunds.org
- IOSCO: Principles for the Valuation of Hedge Fund Portfolios www.iosco.org
- The Open Protocol: Standardised risk reporting procedures www.theopenprotocol.org

RELATED GUIDANCE DOCUMENTS

- AFIC: Développement Durable et Capital Investissement
- AFIC: Charte des Investisseurs en Capital
- BVCA: Guide to Responsible Investment
- BVCA: Walker Guidelines (on GP and portfolio company reporting)
- EVCA: Corporate Governance Guidelines
- EVCA: Governing Principles
- EVCA: Reporting Guidelines
- IIGCC: A Guide on Climate Change for Private Equity Investors
- ILPA: Private Equity Principles 2.0
- IOSCO: Private Equity Conflicts of Interest
- PEGCC: Guidelines for Responsible Investment

UN CONVENTIONS AND INITIATIVES

- UN Global Compact (www.unglobalcompact.org/)
- The Universal Declaration of Human Rights (www.un.org/en/documents/udhr/)
- ILO Declaration on Fundamental Principles and Rights at Work (www.ilo.org/declaration/)
- The Rio Conventions (www.cbd.int/rio/)
- The UN Convention Against Corruption (www.unodc.org/unodc/en/treaties/CAC/index.html)

OTHER INTERGOVERNMENTAL ORGANISATIONS

- OECD Guidelines for Multinational Enterprises (www.oecd.org/daf/investment/guidelines)
- OECD Anti-Bribery Convention (www.oecd.org/daf/nocorruption/convention)
- OECD Principles of Corporate Governance (www.oecd.org/daf/corporateaffairs/principles/text)

INTERNATIONAL FINANCIAL INSTITUTIONS

- IFC Performance Standards (www.ifc.org/ifcext/sustainability.nsf/Content/PerformanceStandards)
- Equator Principles (www.equator-principles.com/index.php)

A comprehensive list of public and private codes, standards and initiatives that may be applicable to portfolio companies is available in the draft ISO 26000 Guidance on Social Responsibility (tables A.1 and A.2, pages 81-90). Further, a range of specific ESG policies and tools are available to PRI signatories on the [*PRI Signatory Extranet*](#).

APPENDIX III: SAMPLE RESPONSIBLE INVESTMENT COMMITMENTS FOR A HEDGE FUND

A generic responsible investment policy in the hedge fund context might include, for instance, the following commitments by a hedge fund manager:

- We are dedicated to conducting ourselves in accordance with the highest legal, ethical and professional standards in our business.
- We will consider environmental, public health, safety, and social issues associated with target companies when evaluating whether to invest, as well as during the period of ownership.
- We will act as a responsible owner if we maintain significant holdings in an investee company over a medium and longer term period, by (a) implement a voting policy and engagement policy which address ESG issues, (b) gathering and analysing information related to voting items before making voting decisions, (c) exercising our voting rights and/or filing resolutions, where appropriate, and by (d) being accessible to, and engaging with, relevant stakeholders.
- We will not borrow shares with the purpose of voting those shares, and we will not vote when we are not economically aligned with other equity holders or when we have an opposing larger short position or other conflicting economic interests.
- We will use governance structures that provide appropriate levels of oversight in the areas of disclosure, valuation, audit, risk management, and potential conflicts of interest and to implement compensation and other policies that align the interests of management and investors.
- We will support compliance at investee companies with applicable national, state, and local labour laws in the countries in which they invest; support the payment of competitive wages and benefits to employees; provide a safe and healthy workplace in conformance with national and local law; and, consistent with applicable law, respect the rights of employees to decide whether or not to join a union and engage in collective bargaining.
- We will support policies at investee companies that prohibit bribery and other improper payments to public officials consistent with the US Foreign Corrupt Practices Act, similar laws in other countries, and the OECD Anti-Bribery Convention.
- We will respect the human rights of those affected by our investment activities and seek to confirm that our investments do not flow to companies that utilize child or forced labour or maintain discriminatory policies.
- We will have regard to the potential impacts of our activities on communities and the market as a whole.
- We will provide timely information to our investors on the matters addressed herein, and work to foster transparency about our activities on these matters.
- We will encourage our investee companies to advance these same principles in a way which is consistent with their fiduciary duties.

Source: PRI Hedge Funds Working Group

APPENDIX IV: UNIVERSITIES SUPERANNUATION SCHEME'S (USS) RESPONSIBLE INVESTMENT EXPECTATIONS FOR THE GOVERNANCE OF HEDGE FUNDS

OVERVIEW

- Challenge is that the hedge fund community represents a very diverse group of organisations.
- Key advantage for investors is that hedge funds can be niche/opportunistic re: strategies that are employed.
- Difficult to define and prescribe industry wide-standards for broad range of strategies
- Improvement of governance of 'institutional investor quality' hedge funds should be top of the industry's agenda as a way of demonstrating willingness to improve accountability and oversight.
- Starting point would be to ensure good, competent and independent directors are appointed to the boards of hedge funds.
- USS would expect a majority of independent directors with requisite skills-sets and experiences to be appointed to all boards including an independent chair.
- The other key priority should be for hedge fund managers to clearly and transparently disclose details of the Fund governance structure which is in place.
- We would also want to see independent administration, good quality service providers

The recommendations listed below are presented as best practice guidelines which we would expect the hedge funds in which we invest to commit to implementing. They are presented on a 'comply or explain' basis. six key areas are addressed:

1. BOARD STRUCTURE

- Optimal number of board members – 5.
- An executive director should be a member of the board.
- Majority of directors should be independent and non-corporate services.
- The chairman should be appointed from the cohort of independent directors who will have the casting vote.
- 1 person to fulfil the role of a company secretarial function who will be domiciled in the market in which the Fund is registered and will be familiar with local regulatory practices.

2. DEFINITIONS OF INDEPENDENCE

Free from current managerial (professional and/or personal) relationships or associations and other potential conflicts of interest (such as cross-shareholdings).

- Tenure not to exceed 9 years – after which the director should be subjected to annual re-election by investors.
- Most important characteristic – independent frame of mind and ability to provide impartial oversight and to challenge management.

3. INDEPENDENT DIRECTOR'S ROLE AND KEY RESPONSIBILITIES

- Fiduciary responsibility to shareholders to ensure the Fund is run in investors' interests and directors are held accountable to them for the stewardship of the Fund.
- To attend – in person – all board meetings.
- To provide an impartial and objective perspective on Fund-related matters.
- To provide appropriate oversight of financial statements to ensure management is investing in a manner and into securities and instruments that are consistent with the stated objectives of the Fund.
- To review and approve periodic valuations that have been supplied by third parties and to be the final arbiter in resolving disputes over valuations.
- To assess and approve:
 - the imposition of suspensions of redemptions
 - the imposition of gates
 - the reasonableness of discretionary fees charged
 - the appointment of key service providers such as auditors and administrators.
- To oversee the work undertaken by the service providers to ensure that it meets the needs and requirements of the Fund – the directors should be granted unfettered access to the auditors and administrators for this purpose.
- To address and resolve any potential conflicts of interest that may arise between the managers and the shareholders.
- To ensure that the fees and expenses incurred by the Fund are fair and reasonable.
- In the event of a wind-down of the Fund, the directors are responsible for ensuring and overseeing an orderly and expedient liquidation of the Fund's assets and the equitable dispersal of proceeds.

4. TIME COMMITMENT AND FEE

- Shareholders will expect independent directors to allocate sufficient time to the Funds to which they are appointed to undertake their role and carry out their responsibilities effectively.
- The maximum number of directorships which any one individual (independent directors) should take on board is likely to be between 10-15 – appropriate consideration to be given for Master-Feeder relationships and Families of Funds.
- Directors' fees to be commensurate with their enhanced role and responsibilities.

5. SKILL SETS/CHARACTERISTICS/ BACKGROUND

- Important to ensure that the skill-sets and backgrounds of board members (chairman's responsibility) are complementary. Skills to be represented include:
 - Minimum of 15 years experience in financial services
 - Buy-side investment experience, preferably in the hedge fund sector
 - Accounting/legal experience
 - Familiarity with the markets in which the Fund is engaged
 - Proven ability of holding managers to account

6. VOTING RIGHTS FOR SHAREHOLDERS

- Shareholders should be afforded the right to vote on the following areas at an annual meeting. The resolutions will need to be carried by at least 75% of the votes. The Manager to be excluded from the vote.
 - To appoint and remove the Manager/Investment Manager/Advisor
 - To approve the election of directors
 - To approve the winding-up of the Fund
 - To approve directors' fees
 - To approve changes to material terms of the Fund – PPM &/or Mem & Arts

ABOUT THE PRI INITIATIVE

The Principles for Responsible Investment (PRI) Initiative is a partnership between the United Nations and global investors with the goal of promoting and mainstreaming responsible investment practice. Launched in 2006 by UNEP Finance Initiative and the UN Global Compact, the PRI Initiative has become the leading network for investors to learn and collaborate to fulfil their commitments to responsible ownership and long-term, sustainable returns.

Pension funds, insurance companies, sovereign wealth and development funds, investment managers, service providers and other supporters make up the PRI network. Our goal is to grow investor interest in environmental, social and corporate governance (ESG) issues, support signatories in their fulfilment of the six PRI Principles, and contribute to the debate about the role of the investor in the creation of a sustainable financial system that rewards long-term responsible investment and benefits the environment and society as a whole.

ABOUT THE WORK STREAM

The work stream was formed in 2011 to explore the many issues around responsible investment in hedge funds. This is the second edition of this publication, which was first released as a pilot in March 2012.

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OUR UN PARTNERS

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UN Global Compact

Launched in 2000, the United Nations Global Compact is a both a policy platform and a practical framework for companies that are committed to sustainability and responsible business practices. As a multi-stakeholder leadership initiative, it seeks to align business operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to catalyse actions in support of broader UN goals. With 7,000 corporate signatories in 135 countries, it is the world's largest voluntary corporate sustainability initiative.

More information: www.unglobalcompact.org