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Public Interest Comment on the Dubai Financial Services Authority's Proposed Hedge Fund Code of Practice Consultation Paper No. 50[1]

October 3, 2007

The Regulatory Studies Program ("RSP") of the Mercatus Center at George Mason University is dedicated to advancing knowledge of the impact of regulation on society. As part of its mission, RSP conducts careful and independent analyses employing scholarship from law, economics, and related disciplines to assess rulemaking proposals from the perspective of the public interest. This Public Interest Comment ("Comment") on Consultation Paper No. 50 of the Dubai Financial Services Authority ("DFSA") does not represent the views of any particular affected party or special interest group, but is designed to evaluate the effect of the proposed rules on overall consumer welfare.

On July 3, 2007, the DFSA issued Consultation Paper No. 50 (the "Consultation Paper") seeking comment on the DFSA's Proposed Hedge Fund Code of Practice (the "Code").[2] The Code was issued in July 2007, one year after Dubai's Collective Investment Law and Collective Investment Regime (the "CIF Regime") applicable to hedge funds became effective. The Code proposes a series of hedge fund best practices under nine general principles relating to issues such as what skills, resources, processes, and systems a hedge fund operator should have; portfolio risk management; valuation practices and policies; and conflicts of interest.[3] Compliance with the Code is not required for hedge funds operating in the Dubai International Financial Centre. However, compliance with the code provides strong evidence indicating that the fund is also in compliance with the relevant legal requirements of the CIF Regime.[4]

The DFSA defines a "hedge fund" as a pooled investment fund which generally has "a broad mandate giving its Operator flexibility to shift strategy"; seeks to achieve absolute

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[1] Prepared by Houman B. Shadab, J.D., senior research fellow, Regulatory Studies Program. This comment is one in a series of Public Interest Comments from the Mercatus Center's Regulatory Studies Program and does not represent an official position of George Mason University. This comment is adopted from Houman B. Shadab, *Fending for Themselves: Creating a U.S. Hedge Fund Market for Retail Investors*, 11 N.Y.U. J. LEGIS. & PUB. POL'Y (forthcoming 2008).
[2] DFSA, CONSULTATION PAPER NO. 50, PROPOSED HEDGE FUND CODE OF PRACTICE 2 (July 3, 2007), *available at* http://www.complinet.com/file_store/pdf/rulebooks/DFSA_CP50.pdf.
[3] DFSA, HEDGE FUND CODE OF PRACTICE 2 July 2007, avail*able at* http://www.complinet.com/file_store/pdf/rulebooks/DFSA_CP50_AnnexA.pdf.
[4] *Id*. at 3.

returns rather than returns relative to the market; charges investors incentive fees based upon performance in addition to management fees based upon total assets under management; and employs trading techniques such as short-selling, derivatives trading, and leveraged trading.[5]

The Code utilizes a principles-based approach toward best practices, as opposed to a detailed prescriptive approach, which articulates general norms regarding how a hedge fund should operate so as to achieve a sufficient level of efficiency, transparency, and fairness in its operations. The DFSA adopted a principles-based approach to "promote certainty while allowing industry participants a degree of flexibility to adapt these standards to suit their particular businesses in light of changing market conditions and emerging issues."[6] This Comment addresses the following issue raised by the DFSA:

> Does the industry prefer a more prescriptive approach, at least in some areas of Hedge Fund operations covered by the Code? If so, why?[7]

Historically, hedge funds have not expressed a preference for a more prescriptive and detailed approach towards best practices. As implied by the DFSA's justification for adopting a principles-based approach, the diverse and dynamic nature of the hedge fund industry is not well-suited for a prescriptive and detailed code of specific best practices.

The hedge fund industry is made up of a very diverse group of investment funds investing in a vast array of real and synthetic assets and employing a wide range of investment techniques, operational practices, and relationships with their investors, prime brokers, and other parties. Hedge funds also adopt a wide variety of specific risk management practices, valuation policies, internal control systems, and other practices and policies falling within the scope of the best practices Code. Modern finance scholarship finds that hedge funds generate "alpha," i.e., their risk-adjusted returns are generally superior to that of traditional, long-only investment funds.[8] Hedge funds' ability to generate alpha has not been found to be correlated to the adoption of any specific valuation technique or other best practice. To the contrary, superior risk-adjusted performance exists across a wide variety of different fund types likely employing a

[5] DFSA, *supra* note 2, at tbl. A.
[6] *Id*. at 4.
[7] DFSA, *supra* note 3, at 2.
[8] *See* Kosowski, Narayan Y. Naik & Melvin Teo, *Do Hedge Funds Deliver Alpha? A Bayesian and Bootstrap Analysis*, 84 J. FIN. ECON. 229, 262-63 (2007); Bill Ding & Hany A. Shawky, *The Performance of Hedge Fund Strategies and the Asymmetry of Return Distributions*, 13 EUR. FIN. MGMT. 309, 329 (2007) (finding that from 1990 to 2003, all hedge fund categories achieve above average performance when measured against an aggregate equity market index.); Robert; Peng Chen & Roger Ibbotson, *The A,B,Cs of Hedge Funds: Alphas, Betas, and Costs* 14 (Yale International Center for Finance, Working Paper No. 06-10, September 2006) (finding that "when combined with stock, bond, and cash portfolios, hedge funds add positive alpha and excellent diversification"); Henry M. Kat & Joëlle Miffre, *The Impact of Non-Normality Risks and Tactical Trading on Hedge Fund Alphas* 16-17 (Cass Business School, City University London Faculty of Finance Working Paper Series WP-FF-21-2005, May 24, 2006) (finding the representative hedge fund manager to have superior trading skills but noting that previous studies and their own may overstate alpha); Daniel Capocci & Georges Hübner, *Analysis of Hedge Fund Performance*, 11 J. EMPIRICAL FIN. 55, 77 (2004) (finding that hedge funds as a whole "[d]eliver significant excess returns").

diverse range of particular best practices. This indicates that the ability of hedge funds to adopt a wide variety of specific best practices allows the funds to tailor such practices to their firm-specific investment strategies, operations, and other particular circumstances in a way that benefits investors. Accordingly, a detailed and prescriptive approach would likely conflict with the efficient adoption of particular best practices and ultimately undermine the interests of investors. Although particular hedge funds may be able to improve their best practices,[9] the generation of alpha across a diverse group of funds cautions against the DFSA implementing a detailed, "one-size-fits-all" code of best practices.

The effect of the ability of hedge funds to adopt a wide variety of governance, compensation, and redemption practices and policies is also instructive. Finance researchers generally find that investors are better off when managers have the discretion to adopt a wide variety of governance, compensation, and redemption practices. This finding suggests that hedge funds' ability to adopt their own specific best practices likely has the same effect. For instance, although not generally required by law, the investment manager or operator of a hedge fund usually co-invests a significant portion of capital directly into the fund.[10] Co-investment aligns incentives between managers and investors and thereby leads to higher performance. A recent study by Agarwal et al. found a positive and significant correlation between managerial ownership and performance such that a 1 percent increase in ownership was associated with higher returns of about 1.5 percent.[11]

Furthermore, as the DFSA notes in its definition of hedge fund, compensation for the general partner-manager comes from two sources. Hedge fund managers charge investors an annual management fee typically ranging from 1 to 2 percent of total assets under management.[12] The manager also charges a performance-based incentive fee ranging from 15 to 20 percent of the fund's gains.[13] Hedge funds typically often employ high water marks and hurdle rates. A high water mark limits the manager's performance fee to only a portion of the gains in a given investor's account, meaning that an investor will not be charged a performance fee until any previous losses are recouped.[14] A hurdle rate is the minimum rate of return a fund must achieve before a performance fee can be charged

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[9] DELOITTE, PRECAUTIONS THAT PAY: RISK MANAGEMENT AND VALUATION PRACTICES IN THE GLOBAL HEDGE FUND INDUSTRY 2, 8, 12-13 (2007) (noting deficiencies in hedge fund practices such as insufficient utilization of independent third-parties for valuation and insufficient use of stress testing).

[10] *See*, *e.g.*, SCOTT J. LEDERMAN, HEDGE FUND REGULATION § 2:2.2, 2-3 (Incorporating Release #1, March 2007). Using a comprehensive database of hedge funds from 1994 to 2002, Agarawal et al. found the average investment by managers to be 7.1 percent, with the median manager owning 2.4 percent of fund assets. Vikas Agarwal, Naveen D. Daniel & Narayan Y. Naik, *Role of Managerial Incentives and Discretion in Hedge Fund Performance*, 13, 35 (Centre for Financial Research Working Paper No. 04-04, April 28, 2006), *available at* http://ssrn.com/abstract=889008.

[11] Agarwal et al., *supra* note 10, at 5, 12-13, 36. *See also* Cecile Le Moigne & Patrick Savaria, *Relative Importance of Hedge Fund Characteristics*, 20 FIN. MARKETS PORTFOLIO MGMT. 419, 424 (2006).

[12] SHARTSIS FRIESE LLP, DOUGLAS L. HAMMER ET AL. U.S. REGULATION OF HEDGE FUND INVESTORS 327 (2005) [hereinafter SHARTSIS].

[13] JAMES R. BARTH ET AL., HEDGE FUNDS: RISKS AND RETURNS IN GLOBAL CAPITAL MARKETS, MILKEN INSTITUTE 32-33 (December 2006).

[14] SHARTSIS, *supra* note 12, at 329.

but is relatively uncommon among the funds.[15] Empirically, most studies find a positive correlation between the level of incentive fees and performance.[16] Agarwal et al. found that hedge funds perform better when fund managers have more incentives, as measured by higher performance fees, more managerial co-investment into the fund, and higher high water marks.[17] The evidence is mixed regarding the impact of performance fees and high water marks on the chances of hedge fund failure although no study finds funds with higher incentive fees and high water marks have an increased probability of failure.[18]

Although hedge funds allow investors to redeem shares on a quarterly or other periodic basis,[19] they also typically limit the ability of investors to redeem their shares. A fund may implement a "lockup" period prohibiting an initial investment to be withdrawn anywhere from six months to two years, require prior notice before funds can be removed, and limit how much capital can be withdrawn on a given date.[20] Agarwal et al. found that greater managerial discretion in the form of longer lockup, notice, and redemption periods was correlated with higher performance. They attribute this finding to greater discretion allowing managers to be more flexible or capture the gains from investing in illiquid assets without investors prematurely withdrawing funds.[21] Studies have also found that funds with longer lockup periods and less frequent redemption policies are less likely to fail.[22] High water marks may also be used to induce investors to make long-term capital commitments through longer lockup and notice periods. Longer

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[15] *Id*. at 330-31 (noting that a hurdle rate may structured to only enable the manager to charge a fee on gains above the hurdle rate, or allow a performance fee to be charged on the entire gains so long as the hurdle is exceeded).

[16] Walter Géhin, *A Survey of the Literature on Hedge Fund Performance* 2.1.4 (EDHEC Risk and Asset Management Research Centre, October 2004) (reviewing mixed findings on the relation between performance fees and fund performance); Biang Liang, *On the Performance of Hedge Funds,* 55 FIN. ANALYSTS J. 72, 78 (1999) (finding that "a high incentive fee is able to align the manager's incentive with fund performance"); Franklin R. Edwards & Mustafa O. Caglayan, *Hedge Fund Performance and Manager Skill*, 21 J. FUTURES MARKETS 1003, 1014 (2001) (finding based upon a sample of hedge funds from January 1990 to August 1998 that "successful hedge funds appear to pay much higher incentives fees"); Hung-Gay Fung et al., *Global Hedge Funds: Risk, Return, and Market Timing*, 58 FIN. ANALYSTS J. 19, 25-26, 28 (2002) (finding that incentive fees have a significant positive impact on a hedge fund's risk-adjusted return); BARTH et al., *supra* note 13, at 60 (finding that higher performance fees have no impact on fund performance).

[17] Agarwal et al., *supra* note 10, at 3-5. *See also* Liang, *supra* note 16, at 74 (finding that funds with high watermarks outperformed funds without).

[18] BARTH et al., *supra* note 13, at 63-64 (funds with higher management and performance fees are less likely to fail); Naohiko Baba & Hiromichi Goko, *Survival Analysis of Hedge Funds* 27 (Bank of Japan Working Paper, March 2006) (finding funds with higher performance fees are less likely to be operational while funds with higher high water marks are more likely to be operational); Guillermo Baquero, Jenketer Horst & Marno Verbeek, *Survival, Look-Ahead Bias and the Performance of Hedge Funds*, 40 J. FIN. QUANT. ANAL. 493, 504 (2005) (finding "the higher the incentive fee, ceteris paribus, the more likely it is that the fund will liquidate in the next quarter").

[19] SHARTSIS, *supra* note 12, at 3.

[20] LEDERMAN*, supra* note 10, at § 2:3.3, 2-16-17. BARTH et al., *supra* note 13, at 38-41 (showing that a majority of hedge funds have a lockup period of less than one quarter).

[21] Agarwal et al., *supra* note 10, at 9, 17. *See also* Liang, *supra* note 16, at 78 (1999) (finding hedge fund performance to be higher the longer the lockup period).

[22] BARTH et al., *supra* note 13, at 63-64; Baba & Goko, *supra* note 18, at 27 (finding that "funds with a longer redemption notice period and a lower redemption frequency have higher survival probabilities.").

capital commitments can benefit investors as a whole where the fund invests in illiquid assets that may expose the fund to the risk of investors overreacting to a short-term asset price decline by seeking to redeem shares all at once.[23]

Not only is there great diversity among hedge funds, but, as recognized by the very definition of “hedge fund” adopted by the DFSA, a characteristic feature of each fund is its flexibility. Unlike traditional, long-only investment funds which typically do not change their particular investment strategy or classes of assets they invest in, hedge funds are relatively flexible and may switch strategies and the types of assets they invest in over time.[24] Investment flexibility likely benefits investors by allowing managers to adapt to changing market conditions. Indeed, a study by Baghai-Wadji and Klocker found that poorly performing funds generally perform better after switching styles.[25] More generally, because the global hedge fund industry is currently undergoing a period of rapid growth and institutionalization, the specific set of best practices most suited for the funds is likewise evolving. As hedge fund investment strategies and operations evolve over time, any detailed set of specific best practices will eventually fail to apply to and meet the needs of the funds.

In sum, the DFSA should refrain from adopting a prescriptive and detailed code of best practices applicable to hedge funds. A detailed list of best practices is likely to be inapplicable to a substantial portion of the funds due to their diversity and would likely conflict with the actual best practices required by particular funds to achieve optimal performance and benefit investors. Furthermore, as the hedge fund industry evolves and grows, any detailed list of best practices is sure to become obsolete as the funds adopt new investment strategies and other practices.

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[23] George O. Aragon & Jun “QJ” Qian, *Liquidation Risk and High-Water Marks* 24 (Working Paper, March 2006), *available at* http://www.mfrc.mcgill.ca/documents/QianJun.pdf.
[24] LEDERMAN, *supra* note 10, at § 1:2.3, 1-14.
[25] Ramin Baghai-Wadji & Stefan Klocker, *Performance and Style Shifts in the Hedge Fund Industry* 33-34, 36-37 (Vienna University of Economics and Business Administration Working Paper, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=920444.