REPORT ON
FUNDS OF HEDGE FUNDS

FINAL REPORT

REPORT OF THE TECHNICAL COMMITTEE
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I. Executive Summary

In its report entitled "*Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds*" as published in February 2003 ("IOSCO 2003 Report"),[1] the IOSCO Technical Committee ("TC") considered the particular regulatory issues arising from the investment of retail investors into hedge funds and described some approaches for addressing the consequences of such issues upon retail investors. The report further underlined that most regulators were more concerned with funds of hedge funds than with hedge funds themselves, as the former are the primary vehicles used for attracting retail investment in the hedge fund area.

In consideration of the increasing popularity of funds of hedge funds among retail investors and of the important regulatory developments made in this area in various jurisdictions, the TC decided in February 2007 that further work should be carried out under a new mandate with a view to assessing whether the regulatory principles presented in the IOSCO 2003 Report needed to be amended and/or completed. It specified that this work focused on retail oriented funds of hedge funds.

In this regard, this Report is therefore issued. Pursuant to the aforesaid mandate, this Report examines on the first hand, the existing regulations of funds of hedge funds (or proposed regulations) in various TC Standing Committee on Investment Management ("SC5") member jurisdictions, and identifies on the second hand, with the help of industry representatives, present issues of concern to regulators in this area. This Report finally proposes on the basis of the SC5 members' assessment, to consider the potential development in specific areas of "e*lements of international regulatory standards on funds of hedge funds*" based on best market practices.

● ***Description of the general regulatory approaches in relation to funds of hedge funds***

This Report provides for the key features of the SC5 jurisdictions' regulatory frameworks in relation to funds of hedge funds offered to retail investors. In particular, the Report shows that in many cases, there is a real convergence of the national regulations but also of the national practices in the area. Although there is no common definition of the fund of hedge funds concept worldwide, the consultation of the SC5 members reflects that most jurisdictions do regulate or authorize funds of hedge funds, and that such regulation is for the most part generally based on the common regime (whether legal and/or regulatory and/or statutory) applicable to traditional collective investment schemes even if, in some cases, such provisions are complemented by specific rules.

The convergence of the national rules on funds of hedge funds may in particular be acknowledged with regard to the disclosure made to investors (whether prior to or after their investment into the funds of hedge funds). Indeed, most SC5 jurisdictions if not all are very much concerned that investors do understand the product they are buying and are in a position to make an informed assessment and judgment of the relevant fund of hedge funds before investing into it. There is also a true convergence of national rules in respect of the on-going

[1] *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds*, Report of the Technical Committee of IOSCO, February 2003, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD142.pdf.

disclosure owed to investors, typically in relation to the publication of the financial statements (audited annual reports and unaudited semi-annual/quarterly reports) and of the net asset value.

Convergence may also be found in respect of the selection of the underlying hedge funds (which in the majority of SC5 jurisdictions requires that specific eligibility criteria be met even if such criteria may be very different from one jurisdiction to the other) and in respect of the offer of funds of hedge funds to retail investors (which is usually subject to sales conditions or restrictions). It also results from the report that in the vast majority of SC5 jurisdictions, the funds of hedge funds' managers/advisers are subject to the same rules as those imposed upon traditional funds' managers.

Finally, if there is no convergence of the national rules in a few areas (such as, for instance the means to deal with the funds of hedge funds' liquidity), the different regulators do nonetheless share the same concerns.

● ***Presentation of the issues relating to funds of hedge funds as identified with the help of the industry***

- <u>The responses to the public consultation</u>:

The Report presents the responses received from the four organizations that responded to the "*Call for Views on Issues that Could be Addressed by IOSCO on Funds of Hedge Funds*" ("IOSCO Consultation Document") that was released for a three-month public consultation from April until July 2007.[2] In their responses, the respondents insist that the information to be provided to investors should be understandable and useful. To that end, the information should be suitably detailed.

The Report also notes that the consultation respondents have divergent views in different fields and in particular with regard to the selection of the underlying hedge funds, the use of target performance by funds of hedge funds, the conditions or limitations in relation to diversification, the funds of hedge funds' valuation, the use of leverage by funds of hedge funds, the best practices regarding the due diligence to be performed by funds of hedge funds' managers, and the level of transparency on the part of the underlying hedge funds.

- <u>The outcome of the hearings organized with experts of the funds of hedge funds' industry worldwide[3]:</u>

For the Report to be as close as possible to the industry's operational practice, the SC5 members organized in the course of 2007, three hearings with experts of the funds of hedge funds' industry worldwide: a hearing in the US (Washington, DC) with American experts; a hearing in Europe (Paris) with European experts; and a hearing in Asia (Hong Kong) with Asian experts.

2 *Call for Views on Issues that Could be Addressed by IOSCO on Funds of Hedge Funds*, Report of the Technical Committee of IOSCO, April 2007, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD244.pdf.

3 The names of the experts who participated to the hearings are listed in Appendix 3 to this Report.

It results from such hearings that from a general perspective, the IOSCO Consultation Document addresses the whole scope of the relevant funds of hedge funds' issues that may be tackled from a regulatory point of view. The experts further stated that the determination and implementation in the different jurisdictions of high level rules in relation to funds of hedge funds was in the interests of investors as opposed to the application of fragmented regulations from one jurisdiction to the other. The experts also indicated that there was no point in limiting retail investors' access to funds of hedge funds given the increasing interest of these investors.

Finally, the experts identified the following key risks attached to funds of hedge funds and provided preliminary views for the purpose of addressing such risks:

(i) The **risk of misselling funds of hedge funds**: in this respect, the experts stressed the importance of the suitability and "know your customer" tests and of the disclosure of the relevant information to the investors;

(ii) The **liquidity risk**: for the purpose of addressing this risk, the experts suggested several possible actions such as the provision of a regulatory requirement that there be a real consistency between a fund of hedge funds' liquidity and that of its underlying hedge funds, the implementation of a lock-up mechanism, the use of "gates" and the limitation of a fund of hedge funds' investments into underlying hedge funds holding illiquid assets. It is noteworthy that in the opinion of a few experts, the funds of hedge funds' liquidity is not always an issue and may be a means to protect retail investors' interests;

(iii) The **valuation risk**: the experts proposed two measures for the purpose of tackling this risk: the first one consists in not investing in any asset that could not potentially be priced (and/or for which it would not be clear how it was priced) whereas the second one aims at prohibiting the payment of all redemption monies on the basis of the estimated net asset value;

(iv) The **operational/fraudulent risk related to the underlying funds**: the experts stressed the importance of the due diligence process to be carried out by funds of hedge funds' managers for the purpose of selecting and monitoring the underlying hedge funds. The experts specified that for such due diligence to be efficient, it had to be simple, straightforward and complied with at all times. They further indicated that if in practice the implementation of the due diligence process by funds of hedge funds' managers could be said to be an easy task, they identified a few obstacles to the performance of a thorough due diligence, notably the poor level of disclosure of certain hedge funds, and the young age of hedge funds globally (i.e., less than three years old);

(v) The **other issues** raised by the experts relate to the lack of harmonization of the funds of hedge funds' regulations (therefore preventing any cross-border regulation), as well as the level playing field issue between competing financial products.

● ***General conclusion: IOSCO's future work***

In the light of the description of the SC5 members' funds of hedge funds' regulations, and of the present issues of concern as identified with the help of the industry representatives, this Report:

- globally confirms the observations made and the related investor protection regulatory issues emphasized in the IOSCO 2003 Report;

- further points out that funds of hedge funds are largely regulated or authorized in the majority of SC5 jurisdictions, the applicable rules being generally based on the regime for traditional collective investment schemes as potentially completed by specific rules;

- nonetheless identifies additional investor protection regulatory issues given that in a few areas, the regulation is either too light if not non-existent, or is too general, which could raise concerns for regulators. This Report therefore proposes to potentially consider further work for the purpose of determining whether guidelines are needed in the particular areas to complete those provided for by the IOSCO 2003 Report and in particular, for the purpose of developing guidelines in relation to the methods that might be utilized by funds of hedge funds' managers in order to deal with the liquidity risk, and the nature and the conditions of the due diligence process to be carried out by funds of hedge funds' managers (in particular in relation to valuation) prior to and during investment.

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II. Introduction

In February 2003, the TC approved and publicly released the IOSCO 2003 Report. The purpose of the IOSCO 2003 Report was to look into the regulatory issues arising from the investment of retail investors into hedge funds. The IOSCO 2003 Report identified particular regulatory issues created by hedge funds and those specific to funds of hedge funds. It further described some approaches for addressing the consequences that these issues might have on retail investors. It also underlined that most regulators were more concerned with funds of hedge funds than with hedge funds themselves, as the former are the primary vehicles used for attracting retail investment in the hedge fund area.

Since the issue of the IOSCO 2003 Report, the volume of traded funds of hedge funds has increased tremendously and significant regulatory developments have taken place in several jurisdictions. In light of the evolving and changing context, in February 2007, the TC granted a new mandate to SC5 regarding funds of hedge funds.

The purpose of the SC5 mandate is to review the content of the IOSCO 2003 Report and in particular, to assess whether the regulatory principles presented in the IOSCO 2003 Report need to be amended and/or completed. More specifically, the mandate directs SC5 to:

- examine the regulation (and proposed regulation) among the SC5 member jurisdictions regarding funds of hedge funds;

- identify any issues of concern to regulators in relation to funds of hedge funds; and

- based on the SC5 members' assessment, to develop "e*lements of international regulatory standards on funds of hedge funds*" on the basis of best market practices.

The SC5 mandate is primarily focused on retail oriented funds of hedge funds.

In April 2007, the TC launched a three-month public consultation to solicit views and comments from all interested parties about regulatory issues arising from funds of hedge funds. Submissions were received from four organizations in response to the IOSCO Consultation Document[4]. SC5 organized three hearings with experts from the funds of hedge funds' industry worldwide, which further helped identify the key issues related to these products.[5] After consideration of the comments received on the IOSCO Consultation Document and the hearings, this Report was issued.

Different events indicate that the SC5 mandate on funds of hedge funds is timely:

- The practice confirms that funds of hedge funds (as opposed to hedge funds) generally are and remain the preferred investment vehicles for offering retail investors access to hedge fund techniques. As a matter of fact, funds of hedge funds are increasingly targeted and designed for distribution to retail investors. This is one of the main reasons why the assets under management of the three thousand funds of hedge funds worldwide have significantly

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4 A feedback statement on the public comments received in response to the IOSCO Consultation Document is attached as Appendix 2 to this Report.

5 The names of the experts who participated to the hearings are listed in Appendix 3 to this Report.

increased in recent years.[6] This increased participation of retail investors in funds of hedge funds raises various regulatory issues and in particular, investor protection issues.

- The funds of hedge funds subject has been actively discussed in the European arena. In a report published in 2006,[7] a group of hedge funds' practioners that had been asked by the European Commission to contribute to the public debate on the development of the hedge fund business in Europe, stated that,

> "In particular, several Member States have authorized the sale of **funds of hedge funds** to retail investors on the grounds that they provide diversified exposure to this asset class. This has been the case for instance, in France, Germany, Ireland, Luxembourg and Spain. Whilst there are concerns regarding the level of product regulation that some of these regimes introduced, the Group welcomes this approach and believes funds of hedge funds (or well diversified hedge funds) **could provide significant benefits to a wide range of investors for whom the case may be that investment in offshore or traditional hedge funds is not appropriate.**"[8] (**emphasis added**)

In addition, the group requested that nationally regulated hedge funds products be mutually recognized as suitable for sale to the investing retail public across Europe.

- Many jurisdictions consider that the regulation of funds of hedge funds has become a priority. Some jurisdictions have already or are in the process of adapting their legal and regulatory framework in consideration of the increasing popularity and success of funds of hedge funds among the retail investors.

One could cite for instance the UK, where the Financial Services Authority ("FSA") published in March 2006, a feedback statement document entitled, *Wider-range Retail Investment Products: Consumer protection in a rapidly changing world – Feedback on DP05/3*,[9] which proposed, among other things, to extend the range of "Non-UCITS Retail Schemes" ("NURSs") to include funds of unregulated schemes. This proposal is based on the ground that there is some competition distortion between funds of hedge funds that can be admitted to official listing and funds of unregulated collective investment schemes that cannot be authorized for distribution as a retail collective investment scheme. It is interesting to note that most respondents to a previous FSA consultation paper[10] considered that funds of unregulated schemes should be made available to retail investors with a protection to be provided by the fund manager being domiciled in the UK and hence subject to the FSA rules.

6 For instance, funds of hedge funds' assets under management were assessed to amount to less than 50 billion dollars (US) in 1999 and to range from 700 to 1,000 billion dollars (US) in July 2007 (depending on whether you use the Hedge Fund Research or Barclay data bases).

7 Report of the Alternative Investment Expert Group to the European Commission, *Managing, Servicing and Marketing Hedge Funds in Europe*, July 2006, available at http://ec.europa.eu/internal_market/investment/docs/other_docs/reports/hedgefunds_en.pdf.

8 *Id.* at 22.

9 *Wider-range Retail Investment Products: Consumer protection in a rapidly changing world – Feedback on DP05/3,* UK FSA, March 2006, available at http://www.fsa.gov.uk/pubs/discussion/fs06_03.pdf.

10 Discussion Paper 05/03: *Wider-range Retail Investment Products - Consumer protection in a rapidly changing world* UK FSA, June 2005, available at http://www.fsa.gov.uk/pubs/discussion/dp05_03.pdf.

In addition, many respondents suggested that the regulator lay down other restrictions on concentration and risk spreading, and require appropriate disclosures. The FSA further published in March 2007, a consultation paper setting out proposals for introducing a range of retail-oriented funds of alternative investment funds ("FAIFs").[11] The results of this public consultation are published in a feedback statement and further consultation, which was issued in February 2008.[12]

Another example could be France, where the Autorité des marchés financiers ("AMF") amended or, as the case may be, supplemented in March 2008, its regulation on funds of hedge funds in the light of the recommendations made by the working group[13] launched by the AMF in April 2007. The working group, whose purpose was to reassess the French regulatory framework in relation to funds of hedge funds, issued a report making several recommendations that were put out for a three-month public consultation in September 2007.[14] In consideration of these recommendations and of the outcome of the public consultation, the AMF updated its General Regulation and related instructions with a view to developing a principles-based regulatory approach under which the responsibilities of asset management companies are more clearly defined, and to making technical adjustments to the rules to adapt them to developments in the funds of hedge funds' industry. In particular, the procedures and resources required on the part of funds of hedge funds' management companies in order to perform due diligence have been reaffirmed and presented more clearly, notably as regards the selection, the monitoring and the oversight of the underlying hedge funds.

In accordance with the SC5 mandate, this Report will on the first hand, present the SC5 member jurisdictions' regulatory approaches regarding funds of hedge funds (including the existing regulations or proposed regulations), on the second hand, identify, with the help of industry representatives, the key issues of concern to regulators in this area, and finally, propose on the basis of the SC5 members' assessment, to consider the potential development in specific areas of "*elements of international regulatory standards on funds of hedge funds*" based on best market practices.

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11 CP 07/6 *Funds of Alternative Investment Funds (FAIFs)*, UK FSA, March 2007, available at http://www.fsa.gov.uk/pubs/cp/cp07_06.pdf.

12 CP 08/4 *Funds of Alternative Investment Funds (FAIFs)* – Feedback on CP07/6 and further consultation, UK FSA, February 2008, available at http://www.fsa.gov.uk/pubs/cp/cp08_04.pdf.

13 This working group consisted of representatives of management companies, depositaries, auditors, lawyers, economists, investors and professional associations.

14 *Report of the working group chaired by Philippe Adhemar on the assessment of the French regulatory framework for funds of hedge funds and on possible areas of improvement*, AMF, September 2007, available at http://www.amf-france.org/styles/default/documents/general/7969_1.pdf.

III. The Funds of Hedge Funds Questionnaire

The questionnaire submitted to the SC5 member jurisdictions sought an update with regard to five distinct areas in relation to various aspects of funds of hedge funds' regulation, including:

- the definition of funds of hedge funds;
- the regulation of funds of hedge funds (in particular, as regards their investment restrictions, their process for selecting underlying hedge funds, their liquidity);
- the retail funds of hedge funds' transparency/disclosure;
- the regulation of the funds of hedge funds' managers or advisers; and
- the regulation on the sale of funds of hedge funds (in particular, as regards sales restrictions).

The questionnaire is attached to this Report as Appendix 1.

IV. The General Regulatory Approaches to Funds of Hedge Funds: The Questionnaire Results[15]

It is noteworthy that pursuant to the SC5 mandate, the SC5 member jurisdictions were asked to focus on retail oriented funds of hedge funds[16].

IV.1 The definition of funds of hedge funds: A general overview

In the vast majority of the SC5 member jurisdictions, there is **no legal or formal definition** of the fund of hedge funds concept. Some SC5 members do nonetheless provide in their legal or regulatory framework[17] for some guidance on this notion.

Hence, from a global standpoint, the definition of a fund of hedge funds will derive from the practice and will generally refer to a fund investing most of its assets primarily in hedge funds.

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15 The SC5 member jurisdictions' responses to the questionnaire are current as from 31 December 2007.

16 For the purposes of this Report, which is primarily concerned with the offering of funds of hedge funds to the retail public, a fund of hedge funds in the US refers either to (a) a fund that is registered as an investment company under the Investment Company Act of 1940 that is not currently available to retail investors and that invests primarily in other funds (which themselves are not generally registered as investment companies) ("US-SEC") or (b) a commodity pool that is operated by a commodity pool operator registered with the Commodity Futures Trading Commission and that primarily invests in other funds (*i.e.*, hedge funds) and, with respect to the commodity pool, the commodity pool operator has not claimed any exemption from the reporting, disclosure and recordkeeping requirements that are generally applicable to commodity pools ("US-CFTC") (US-SEC and US-CFTC collectively are referred to as "US"). The US-SEC responses to the questionnaire are current as of 31 December 2007.

17 For instance:

- German law (*i.e.*, § 113 para. 1 of the German Investment Act InvG) provides for the possibility for a fund of hedge funds to invest, among other assets, in hedge funds as such terms are defined in the same law (*i.e.*, § 112) provided the fund of hedge funds does not use leverage or short sales techniques;
- In Hong Kong, a fund of hedge funds authorized by the SFC pursuant to the SFC Code on Units Trusts and Mutual Funds may be offered to retail investors as opposed to a non authorized fund of hedge funds;
- In Spain, some specific rules provide that Spanish funds of hedge funds should invest "at least 60% of their assets in hedge funds constituted in Spain or in foreign hedge funds domiciled in OECD countries or whose investment managers are domiciled in OECD countries and under prudential supervision;"
- French regulation expressly provides that a French collective investment scheme may be created in the form of a fund of hedge funds subject to certain regulatory conditions. AMF's instruction n° 2005-02 of 25 January 2005 as amended ,defines a fund of hedge funds as a fund exposing more than 10% of its portfolio to French or foreign funds using hedge fund or alternative investment techniques and satisfying specific regulatory conditions; and
- In Brazil, funds of hedge funds are defined as a category of funds of funds. They must invest at least 95% of their assets in other funds. The target funds may belong to any other categories of funds provided they are regulated by the same general rule (Instruction CVM 409). Funds of hedge funds may however invest up to 20% of their assets in funds regulated by specific rules (such as real estate funds and credit right funds (*e.g.*, asset backed securities funds)).

Under these circumstances, it is therefore difficult to establish precise estimates on the number of funds of hedge funds and on their assets under management on a country by country basis.[18]

Funds of hedge funds are structured in significantly different ways from one SC5 member jurisdiction to the other. In practice, funds of hedge funds may be organized as investment trusts (*e.g.*, Canada Ontario, Canada Quebec, Hong Kong, Ireland, Japan), limited partnerships (*e.g.*, Canada Ontario, Canada Quebec, Switzerland, US), limited liability companies (US), investment companies (*e.g.*, France, Hong Kong, Ireland, Japan, Luxembourg, Spain, Switzerland, US-SEC), or other contractual forms of funds such as mutual funds (*e.g.*, France, Ireland, Luxembourg, Spain, Switzerland). In some jurisdictions, funds of hedge funds may be created in the same form as that of domestic collective investment schemes using traditional investment techniques (*e.g.*, France, Luxembourg, the Netherlands, Switzerland). In addition, depending on the country, funds of hedge funds may be open-ended (*e.g.*, France, Switzerland) or closed-ended vehicles (*e.g.*, Canada Ontario, Canada Quebec, Switzerland, UK, US).

IV.2 The regulation of funds of hedge funds

General perspective of the funds of hedge funds' regulation

Interestingly, **most of the SC5 member jurisdictions[19] do regulate or authorize funds of hedge funds**. Many of them will further require registration of the funds of hedge funds (*e.g.*, Australia (if the fund of hedge funds is a collective investment scheme), Brazil, France (if the fund of hedge funds is not created in the contractual form), Canada Ontario, Canada Quebec and Hong Kong (if the fund of hedge funds is offered to the public), Jersey (if the fund of hedge funds is a company), Spain, Switzerland, UK (if the fund of hedge funds is organized as a listed investment company or an authorized open-ended Qualified Investor Scheme (and in future if it is a retail oriented authorized open-ended collective investment scheme)) and the US (if the fund of hedge funds is an investment company)). Where the fund of hedge funds falls within the jurisdiction of the US-CFTC, the US-CFTC requires registration of the fund's operator.

Funds of hedge funds' regulation is usually based on the legal/regulatory/statutory framework which is applicable to common collective investment schemes (*e.g.*, Australia, Brazil, Canada Ontario, Canada Quebec, France, Hong Kong, Jersey, Luxembourg, Mexico, and the Netherlands).

Many jurisdictions nevertheless provide for specific rules regarding funds of hedge funds for the purpose of completing the applicable general provisions on collective investment schemes (*e.g.*, Brazil, France, Germany, Hong Kong, Ireland, Portugal, Spain, Switzerland, and US).

It is interesting to note that in some cases, specific rules are provided for in relation to funds of hedge funds which are not intended for retail distribution *i.e.*, funds of hedge funds addressed to qualified or sophisticated investors as opposed to retail investors. This would notably be the case in the UK (where funds of hedge funds are organized as closed-ended

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18 Given the various regulatory approaches, it does not seem relevant to compare the different figures provided by the SC5 member jurisdictions.

19 With the exception of Japan and China.

investment companies[20], listed on the stock exchange and therefore subject to the UK Listing Rules and the EU Prospectus Directive[21]), Canada Ontario and Canada Quebec (where funds of hedge funds not offered to the public are exempted from certain rules), Hong Kong (where funds of hedge funds distributed to professional investors as such terms are defined by law are exempted from authorization), and Switzerland (in relation to funds of hedge funds distributed to qualified investors as such terms are defined by law).

As a general conclusion, most of the SC5 member jurisdictions do authorize funds of hedge funds even though the conditions imposed upon such funds may be very different from one country to the other (as shown in this Report). In any case, no jurisdiction expressly prohibits funds of hedge funds as such. The requirements found in the SC5 member jurisdictions' regulation on funds of hedge funds generally derive from the common regime applicable to the traditional collective investment schemes, with the potential addition of certain specific rules for funds of hedge funds.

With regard to investment restrictions

There are two regulatory approaches in relation to the regulation of funds of hedge funds' investment restrictions.

On the one hand, some jurisdictions do not provide for specific investment restrictions to be complied with by funds of hedge funds in particular as regards the use of leverage, short selling, and derivatives. A few jurisdictions further apply the rules imposed upon funds of funds to funds of hedge funds (*e.g.*, Japan, Jersey). On the other hand, in those jurisdictions where funds of hedge funds are subject to a specific regulation (*i.e.*, the majority of jurisdictions), the regulatory obligations and restrictions generally relate to:

- <u>the credit risk</u> that-is-to-say, the investment into one and the same issuer: in a few jurisdictions (*e.g.*, Germany), a fund of hedge funds may not invest in more than two funds of the same issuer or fund manager, and in the UK, there will be a restriction of the underlying hedge fund investing no more than 15% in other collective investment schemes;

- <u>diversification as regards the investment in the underlying funds</u>: several jurisdictions require that a fund of hedge funds invests no more than a given percentage of the fund's assets in any one underlying fund, or that it invests in a minimum number of underlying funds (*e.g.*, Germany and Ireland, where the fund of hedge funds may not invest more than 20% of its assets into one single fund, Hong Kong where a fund of hedge funds must invest in at least five underlying funds and must not invest more than 30% of its assets in any one underlying fund, Spain where no more than 10% of the fund of hedge funds' assets may be invested into one single fund, the UK where it is proposed that there will be a minimum of three underlyings in the case of a retail authorized investment fund unless it is a feeder fund);

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[20] Whilst in theory it is possible to have a UK authorized fund of hedge funds as an authorized open-ended investment company subject to Qualified Investor Scheme rules, in practice due to taxation issues this does not occur.

[21] Directive n° 2003/71/EC of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (hereafter referred to as the "EU Prospectus Directive").

- the nature of the underlying funds: several jurisdictions require that funds of hedge funds only invest in single hedge funds as opposed to funds of hedge funds or feeder funds (e.g., Germany, Hong Kong, Ireland, Spain);

- the minimum investment into hedge funds: some jurisdictions require that funds of hedge funds invest a minimum percentage of their assets into single hedge funds (*e.g.*, Germany where the minimum threshold is 51% of the fund of hedge funds' assets, Spain where this percentage is 60%);

- the possibility to invest in assets other than underlying hedge funds: some jurisdictions provide for such possibility to a limited extent and/or provided it is specified in the fund's constitutive documents (*e.g.*, Portugal, Switzerland, Germany where a fund of hedge funds may hold cash, invest in funds which exclusively invest in cash and money market instruments, and invest in currency derivatives to hedge against foreign currency risks, France where investments may also be made in financial transferable securities and liquid assets, Italy, Luxembourg, Mexico, the Netherlands, Spain and the US, the UK where it is proposed that funds of hedge funds could invest in any unregulated scheme with a 20% aggregate restriction on unapproved securities). On the other hand, some jurisdictions do not envisage such investments for funds of hedge funds (*e.g.*, Hong Kong);

- the use of leverage and short selling: only a few jurisdictions prohibit the use of leverage and/or short selling by funds of hedge funds on the ground that the purpose of a fund of hedge funds is primarily to invest in hedge funds and that the underlying hedge funds already employ such leverage or short selling techniques (*e.g.*, Australia where short selling is prohibited, Brazil, Hong Kong, Switzerland);

  It is noteworthy that if most of the SC5 member jurisdictions do allow the use of leverage or short selling by funds of hedge funds, they do so to a limited extent only (*e.g.*, France, Germany, Ireland, Mexico, UK, US-SEC). For instance, the use of such techniques would have to be in compliance with the fund of hedge funds' investment objectives and strategies as set out in its constitutive documents (*e.g.*, its prospectus or other offering document, by-laws, articles of incorporation), to be clearly disclosed to investors (e.g., by means of warnings in the fund's prospectus), and/or be limited to a percentage of the fund's net assets (which may differ depending on the country of domicile of the fund and of its legal status[22]);

- the use of derivatives: only a few jurisdictions provide for specific rules regarding the use of derivatives by funds of hedge funds (*e.g.*, Germany, where currency derivatives may only be invested in to hedge foreign currency risks);

- the specific rules applicable to funds of hedge funds by virtue of their legal nature: for instance in the UK, funds of hedge funds created in the form of closed-ended listed investment companies have to abide by the relevant listing rules (*e.g.*, chapter 15 of the FSA Listing Rules) whilst open-ended authorized funds have to comply with the rules on Qualified Investor Schemes.

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22 One could cite for instance French contractual funds for which the limit is contractually determined by the parties.

Hence, in the light of the above, it appears that the specific investment rules that are generally imposed upon funds of hedge funds are, most of the time, very close (if not similar in certain cases), to the ones pertaining to more traditional funds.

With regard to transparency and disclosure

Disclosure to the investor prior to his investment into the fund of hedge funds

► From a general standpoint, it is interesting to note that whatever the nature of the regulation enforced with regard to funds of hedge funds (whether the general regulation applicable to traditional funds or a specific regulation), **the vast majority of the SC5 member jurisdictions require funds of hedge funds to be <u>transparent and to disclose relevant information to investors</u>** <u>particularly in their prospectuses or offering memoranda[23] or listing particulars where applicable[24] or other disclosure document.</u> As a matter of fact, most of them require that such documents be delivered to retail investors prior to any investment. It is further generally required that the information be presented in a clear and comprehensible manner for investors to understand the terms of the proposed investment. The purpose of this information is therefore to enable investors to make an informed assessment and judgment of the fund of hedge funds before investing in it. It is noteworthy that the same objective is sought for in the case of UCITS pursuant to the European UCITS Directive.[25] This shows that the protection of investors' interests is a major concern for jurisdictions, even in the case of less traditional funds such as funds of hedge funds.

In the SC5 member jurisdictions, the information required to be disclosed in a fund of hedge funds' prospectus or offering memorandum will commonly relate to:

- the fund of hedge fund's investment objectives and the strategies that will be used to achieve the contemplated objectives including the use of borrowing, short selling, leverage and derivatives;

- the investment restrictions;

- the related risks;

- the diversification strategy;

- the fees and expenses (such as the total expense ratio, the performance fee);

- the subscription and redemption conditions;

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23 A very few jurisdictions though (*e.g.*, Canada Quebec, Canada Ontario for prospectus exempt funds of hedge funds (*i.e.*, not destined for retail investors), Mexico) do not legally require the production of a prospectus or offering memorandum in relation to funds of hedge funds.

24 For instance, in the UK where funds of hedge funds are typically organized as closed-ended listed companies.

25 Council Directive n° 85/611 of 20 December 1985 as amended on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

- the conditions for the fund's valuation (and in particular the periodicity of the net asset value calculation);

- past performance if relevant;

- taxation;

- the fund's service providers (sponsor, depositary, valuation agent, investment manager, administrator, board of directors if applicable, etc.);

- the fund's constitutive documents (*e.g.*, articles of incorporation for an investment company, regulation for a mutual fund);

- the characteristics of the fund's shares or units;

- the circumstances under which the fund may be liquidated;

- the other documents that are available (*e.g.*, annual financial reports, semi-annual, quarterly and/or monthly financial reports).

This information may also more specifically include warnings (for instance that investors may lose their assets (Brazil, US-CFTC)), and refer to dispute resolution systems (*e.g.*, Australia), the significant benefits (Australia), the due diligence and on-going monitoring process carried out by the investment manager (Hong Kong), the management of conflicts of interests (France, Hong Kong, US-CFTC), a business background and the material legal proceedings against the product or investment manager (US).

It is noteworthy that a few jurisdictions require that investors certify in writing that they are aware of the risks attached to their investment into the fund (*e.g.*, Spain, US-CFTC where the manager may not receive or accept funds until it has received an acknowledgement manually signed and dated that the prospective participant has received a disclosure document).

► As regards the information provided by funds of hedge funds on their investment strategies, **the vast majority of SC5 member jurisdictions require that such information be clear and detailed for the investors to be aware of the strategies actually utilized and the related risks**. A general indication that the fund is invested in all alternative strategies would therefore not be sufficient in most cases.

► The transparency generally applied at the level of funds of hedge funds also relates to the payment of **rebate commissions** by the underlying hedge funds to the funds of hedge funds. **Most of the SC5 member jurisdictions authorize such practice** provided that (i) it is to the benefit of the fund of hedge funds and (ii) it is disclosed to the investors. These jurisdictions usually apply in this respect the general rules applicable to collective investment schemes or funds of funds (*e.g.*, Australia, France, Hong Kong, Ireland, Italy, Jersey, Luxembourg, Portugal, Spain, Switzerland, the UK).

Some jurisdictions though do not provide for any rules with regard to the payment of rebates to a fund of hedge funds (*e.g.*, Brazil, Canada Ontario, Canada Quebec, Germany, Japan, the Netherlands). Finally, one member jurisdiction (US-SEC) prohibits rebates.

On-going disclosure to the investor following his investment into the fund of hedge funds

► Generally, all SC5 member jurisdictions provide for information obligations to the benefit of funds of hedge funds' unitholders or shareholders (*i.e.*, investors who have subscribed into the funds).

A typical information obligation in the SC5 member jurisdictions is the **publication of the audited annual financial statements and of the unaudited semi-annual/quarterly financial statements.**[26] Such reports commonly comprise the same information that is provided for traditional collective investment schemes[27] and may further consist of specific information such as the list of the names of the underlying hedge funds, their managers and domicile (*e.g.*, Ireland).

Depending on the jurisdictions, the annual and semi-annual reports either have to be sent or distributed to unitholders or shareholders (*e.g.*, Canada Ontario, Canada Quebec, Hong Kong, Jersey, US) or to be made available to investors upon their request (*e.g.*, France, Italy).

In some cases, specific periodic reporting is required as regards the fund's performance (*e.g.*, Australia, US-CFTC), the portfolio composition (Brazil, Mexico, Canada Ontario and Canada Quebec which provide for the disclosure of the 25 top positions, US-CFTC), the fund's activities (*e.g.*, Hong Kong where quarterly reports provide for information on the investment manager, the portfolio such as the illiquid holdings, the number of underlying funds and fund managers), the portfolios of the underlying funds on a very regular basis (Japan), the fund's performance history for its past ten fiscal years or its life if in operation for less than ten years (US-SEC). It is noteworthy that in the Netherlands, nearly all funds of hedge funds publish a monthly newsletter.

Finally, **material changes** and significant events regarding the funds of hedge funds are usually required to be disclosed to investors within reasonable delays for them to be in a position to assess the potential impact on their investments and to consider whether to remain invested or not.

► Another typical information disclosure relates to the **calculation and publication of the fund's net asset value**. In most of the SC5 member jurisdictions, a fund of hedge funds is required to publish a net asset value on a regular basis. A monthly publication appears to be the common practice. A few jurisdictions nonetheless require a different periodicity which may be daily (*e.g.*, Brazil, Canada Ontario, Canada Quebec for funds of hedge funds destined for retail investors, Japan, Mexico), quarterly (*e.g.*, France for contractual funds (*i.e.*, not retail oriented), Spain), or semi-annually (*e.g.*, Italy for closed-ended funds, Spain when it is required by the investment strategy). It is noteworthy that two jurisdictions do not require the publication of a net asset value by funds of hedge funds (*i.e.*, the US with regard to funds of hedge funds registered with the US-SEC (*i.e.*, not retail oriented) and Australia).

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[26] It is noteworthy that the US-CFTC requires monthly reporting for pools with greater than $500,000 (US) in capital contributions and at least quarterly for those with less.

[27] Such as a statement on the net assets, a balance sheet, the number of issued units or shares, a report on the investment management performed for the period under consideration including for instance a report on the fund's performance, a schedule on the portfolio's holdings, etc.

As regards the use of the underlying hedge funds' estimated net asset values for the purpose of calculating those of funds of hedge funds, it is legally authorized or accepted in practice in several jurisdictions (*e.g.*, France, Italy, Luxembourg, the Netherlands, Spain[28], the UK, the US). The other jurisdictions either exclude such practice (*e.g.*, Brazil, Germany, Portugal, Switzerland), or do not provide for it in their applicable rules.

The SC5 member jurisdictions' regulation or practice as the case may be, shows that the investors' information, whether before or after the investment into the funds of hedge funds, is a key issue. Moreover, as is the case for investment restrictions, the disclosure obligations applied in respect of funds of hedge funds are quite close to the ones pertaining to traditional funds.

With regard to the funds of hedge funds' liquidity

The funds of hedge funds' liquidity is also a point of concern for regulators, as it depends for the most part on that of the underlying hedge funds. Moreover, investment managers may, in certain circumstances, limit the redemptions by using different tools such as lock-up periods, redemption suspension, deferral and side letters.

► In a majority of SC5 member jurisdictions, funds of hedge funds may provide for **lock-up periods** (*i.e.*, periods during which investors are not entitled to redeem their units or shares in the funds) and/or for the possibility to suspend the redemption of their units or shares. The grounds for the lock-up periods may nonetheless be quite different from one jurisdiction to another.

Generally, lock-up periods are expressly provided for by the law or regulation specifically applicable to funds of hedge funds (*e.g.*, France, Germany, Luxembourg, Spain). In some cases though, the use of lock-up periods is either authorized by the general law on traditional funds (*e.g.*, Australia, Brazil) or results from the practice (*e.g.*, Japan).

The length of these lock-up periods (including limited redemption periods) may be from 60 days (*e.g.*, for French non contractual funds of hedge funds) to several years (*e.g.*, for French contractual funds of hedge funds, Switzerland). It is interesting to note that one jurisdiction (Germany) limits the duration of such periods to 100 calendar days.

Finally, a few jurisdictions do not provide for or authorize lock-up periods at the level of funds of hedge funds (*e.g.*, Hong Kong (particularly in respect of funds of hedge funds offered to retail investors), Ireland, Japan, Jersey).

► It is noteworthy that some jurisdictions do authorize funds of hedge funds to **suspend the redemption** of their units or shares under exceptional circumstances in consideration of the investors' interest (*e.g.*, Brazil, France, Hong Kong, Italy, the Netherlands, Portugal, Spain, Switzerland, the UK). Even though it is not expressly provided for in the regulation, redemption suspension may also derive from the practice of the industry (*e.g.*, Japan). A few jurisdictions nevertheless do not authorize redemption suspension (*e.g.*, Jersey).

[28] The valuation of the underlying funds must be based on the last known net asset value (this means that estimated net asset values which are not subject to a subsequent recalculation are accepted).

► Some jurisdictions also authorize the **deferral of redemption requests** when the latter exceed a certain percentage of the fund's net assets (*e.g.*, in Hong Kong and in Luxembourg where the percentage is 10%) or until the full redemption proceeds from the underlying funds are received by the fund of hedge funds (Ireland).

In any event, in those jurisdictions allowing lock-up periods or redemption suspensions, most of them require that the possibility and the ground for a fund to implement such procedures be clearly disclosed to investors. Such disclosure has to be made at least into the fund's prospectus or other constitutive documents (*e.g.*, Brazil, Canada Ontario, Canada Quebec, France, Hong Kong, Luxembourg, Mexico, the Netherlands, Portugal, Spain, the UK, the US).

► Finally, it is interesting to note that the use of **side letters** which provide preferential redemption rights[29] and portfolio information to certain investors, is **far from being a common practice among the SC5 member jurisdictions**. Most jurisdictions effectively consider that side letters are either strictly illegal or may not be used in practice on the grounds that they are not provided for in the fund of hedge funds' prospectus or offering memorandum, and that they are in breach of the principle pertaining to the equal treatment of investors.

The main concerns arising from the use of side letters actually relate to the potential conflicts of interests and the impact on the fund of hedge funds' liquidity. In certain circumstances, investors not benefiting from side letters may be unable to redeem their units or shares within a reasonable period.

This is one of the main reasons why the few jurisdictions that accept or authorize such practice (*e.g.*, Hong Kong, the UK, the US) require or as the case may be, recommend that an appropriate disclosure of the material terms of the side letters offered to certain investors be made to the fund's unitholders or shareholders as a whole.

On the other hand, the use of side letters might be of interest where they are executed between a fund of hedge funds and the underlying hedge funds in which it invests. In this case, the potential additional liquidity that may be offered pursuant to the side letters will benefit to the unitholders or shareholders of the fund of hedge funds.

With regard to selection of the underlying hedge funds

The selection of the underlying hedge funds by a fund of hedge funds raises several questions in terms of regulation in particular as regards the method used and the information provided on the underlying funds.

A majority of the SC5 member jurisdictions do require that eligibility criteria be met by the underlying hedge funds before they can actually be invested in by funds of hedge funds. Only a few jurisdictions do not provide for such eligibility criteria (*e.g.*, Canada Ontario, Canada Quebec, the Netherlands, Portugal, Switzerland, the US). It should be noted that some of these jurisdictions nonetheless require that disclosure and/or due diligence

[29] Such as a shorter redemption notice period, a right to instantly redeem if a certain portfolio manager leaves the management firm, the possibility to be exempted from redemption gates.

obligations be satisfied (*e.g.*, Canada Ontario, Canada Quebec, Portugal, Switzerland, the US).

The eligibility criteria may be quite different from one jurisdiction to another. Moreover, some jurisdictions will adopt a light and straightforward approach whereas others will follow a somewhat more detailed and restricting procedure.[30]

Globally, the eligibility criteria required in the SC5 member jurisdictions relate to:

- the **status of the underlying hedge fund** (*e.g.*, a domestic fund or a fund registered with the national authority)[31];

- the **nature of the underlying hedge fund**;[32]

- the **diversification at the level of the fund of hedge funds**: this covers both the maximum percentage of the fund's assets that can be invested in any one underlying fund, and the minimum number of underlying funds;

- the **diversification at the level of the underlying hedge funds** which refers to the risk spreading rules to be applied by the said funds;

- the **independent**[33] **or appropriate**[34] **valuation** of the underlying hedge funds' assets;

- the **annual audit of the underlying funds' accounts by an independent auditor**;[35]

- the **safe custody** of the underlying funds' assets[36] (notably the funds' assets shall be segregated from those of the manager);

30 That would be the case for instance in France, Hong Kong, Spain and the UK.

31 For instance, in Australia (where a fund of hedge funds in the form of a collective investment scheme may only invest into another collective investment scheme registered with the authority), in Brazil (where a "multimarket fund of hedge funds" may invest in funds regulated by the authority and subject to strict conditions, in other funds (real estate funds or credit rights investment funds)), in Jersey (where 90% of the underlying hedge funds must be collective investment schemes registered or recognized by the authority), in Mexico (where the underlying fund has to be registered with the national authority or else regulated by a member of the IOSCO TC or of the European Union), in Spain (where the underlying fund must be either a hedge fund constituted in Spain, a collective investment scheme or any other comparable vehicle domiciled in OECD countries or which is managed by a management company or entity performing similar functions which is subject to supervision and domiciled in an OECD country) or in the UK (where funds of hedge funds in the form of open-ended funds may only invest in a regulated collective investment scheme or in any other scheme for which the manager has performed reasonable due diligence).

32 For instance, German law requires that the target fund be a single hedge fund. Other jurisdictions also provide that the target fund may not be another fund of hedge funds (*e.g.*, Hong Kong, Italy, Jersey, Spain). In Brazil, restrictions are imposed upon the target fund when it is of a specific nature (such as a real estate fund).

33 For instance, in the UK.

34 For instance, in France.

35 For instance, in Ireland, in France and in the UK.

36 For instance, in Hong Kong, Ireland and France.

- the **ownership of the underlying funds' units or shares**;

- the **equality of treatment of the underlying funds' unitholders**;

- the **information provided to the investors on a regular basis** in particular as regards the official or estimated net asset value, the management performed, the prospectus (describing notably the investment rules determined for the fund);

- the **limitation of the investors' losses** to the amount of their initial investments;

- the exclusion of funds established in jurisdictions non cooperative pursuant to the FATF rules;

- the experience of the underlying hedge funds' key personnel.

Interestingly, in the vast majority of SC5 member jurisdictions[37], the rules pertaining to the underlying hedge funds (in particular as regards their selection) apply likewise to national and foreign funds. Hence, in most cases, the nationality of the underlying funds is irrelevant.

With regard to the offer or distribution of funds of hedge funds

From a general standpoint, there are among the SC5 member jurisdictions, two approaches regarding the distribution of funds of hedge funds. On the one hand, some jurisdictions do not provide for any particular limitations on the sale of funds of hedge funds. On the other hand, some jurisdictions expressly do require that specific conditions be met before a fund of hedge funds can be distributed to investors. These conditions may differ from one jurisdiction to another depending on the quality of the targeted investors (*i.e.*, retail or sophisticated).

In considering whether the legal or regulatory sales conditions apply in a particular case, a distinction is generally made between funds sold to retail investors and those sold to sophisticated investors (*e.g.*, Brazil, Canada Ontario, Canada Quebec, France, Hong Kong, US-CFTC).

► The offer of funds of hedge funds to retail investors in the SC5 member jurisdictions is globally subject to conditions or sales restrictions which may be either very general or more specific and detailed.

The general conditions would in practice refer to:

- the disclosure of appropriate information (including warnings) in the funds of hedge funds' prospectuses for instance in relation to the related risks (*e.g.*, Australia, France, Ireland, Luxembourg, Mexico, Switzerland, US-CFTC), the investment policy (*e.g.*, Ireland where a glossary of terms must be provided if necessary to give a plain English explanation of the alternative investment strategies that the underlying hedge funds may employ), the targeted investors (*e.g.*, France, Luxembourg), the valuation method used (*e.g.*, Switzerland, US-CFTC), the absence of authorization by the regulator (*e.g.*, France for French contractual funds of hedge funds which are only notified to the

[37] *E.g.*, Australia, Brazil, Germany, Hong Kong, Ireland, , Italy, Japan, Jersey, Luxembourg, Mexico, the Netherlands, Portugal, Spain, Switzerland, the UK.

authority, US-CFTC *i.e.*, in certain cases where relief is claimed, it must be disclosed on the cover page of the disclosure document);

- the legal nature of the funds of hedge funds: some jurisdictions require that funds of hedge funds be created in a specific legal form for them to be offered to retail investors such as a registered collective investment scheme being licensed to provide the relevant financial services to retail investors (*e.g.*, Australia, the Netherlands), or a closed-ended fund enjoying the EU passport under the European Prospectus Directive (in the UK where open-ended collective investment schemes can only be marketed to sophisticated investors, or a body corporate in the case of open-ended Qualified Investor Scheme), or a public closed-ended fund of hedge funds (*e.g.*, Canada Ontario, Canada Quebec) where such fund is subject to the obligation of producing a prospectus as opposed to prospectus exempt funds which may only be distributed to accredited and other qualified investors;

- the registration of the distributor/investment dealer (*e.g.*, Canada Ontario, Canada Quebec for closed-ended exchange traded funds of hedge funds, Hong Kong, Japan);

- the delivery of a detailed and complete prospectus as opposed to a simplified prospectus (*e.g.*, Germany, France for French contractual funds of hedge funds only, US-CFTC);

- the filing of audited annual financial statements, non audited semiannual financial statements, annual and semiannual management reports on fund performance (*e.g.*, Canada Quebec and Canada Ontario in the case of a public closed-ended fund of hedge funds);

- redemption facilities (*e.g.*, at least once a month in Ireland).

The specific conditions imposed upon the offer of funds of hedge funds to retail investors relate in particular to:

- a written declaration on the part of retail investors for the purposes in particular of acknowledging receipt of the prospectus and the risks related to the investment into the fund of hedge funds (*e.g.*, Brazil, Spain, US-CFTC);

- a minimum subscription threshold (*e.g.*, France where the minimum thresholds are either 10,000 Euros or 250,000 Euros depending on the category of funds of hedge funds,[38] Hong Kong where the minimum threshold is US $10,000).

In the light of the above, almost all of the SC5 member jurisdictions that allow the distribution of funds of hedge funds to retail investors, submit such offer to general conditions.

[38] It is noteworthy that no minimum subscription thresholds apply where the fund benefits from a guarantee.

► It is noteworthy that two SC5 member jurisdictions do not however authorize the distribution of funds of hedge funds (in the form of collective investment schemes) to retail investors:

- as mentioned *supra*, in the UK, funds of hedge funds may be organized either as closed-ended investment companies which are subject to the UK Listing Rules and the European Prospectus Directive, or open-ended collective investment schemes which can only be marketed to sophisticated investors (as defined under UK law). Hence, retail investors in the UK have limited ability to subscribe for units of collective investment schemes investing into hedge funds. It is to be stressed though that the UK is currently contemplating authorizing retail investors to access funds of unregulated schemes[39] by extending the range of NURSs to include funds of unregulated schemes which would include funds of hedge funds.

- in the US, funds of hedge funds registered with the US-SEC currently limit their sales to accredited investors[40] as such terms are defined in rule 501(a) of the Securities Act of 1933. None of them actually sell their shares to retail investors. Moreover, funds of hedge funds registered with the US-SEC require their investors to make a minimum initial investment of US $25,000. In addition, if a fund of hedge funds registered with the US-SEC intends to charge a performance fee, each of its investors must be a qualified client, that-is-to-say, a natural person having a net worth exceeding US $1.5 million or investing at least US $750,000 in the fund of hedge funds.

► As regards funds of hedge funds addressed to sophisticated investors, the sales conditions are more flexible (for instance, funds of hedge funds may be sold, in some jurisdictions, without a prospectus) and generally relate to the legal or regulatory status of the investors (*e.g.*, exempt purchasers as defined under the law of Canada Ontario and Canada Quebec, qualified investors as defined under French law and UK law and Swiss law, professional investors as defined under Hong Kong law, accredited investors as defined under US law), the minimum investment amount (*e.g.*, 500,000 Euros in Italy), the maximum number of investors (*e.g.*, 200 in Italy), the nature of the offer (*e.g.*, Italy where funds of hedge funds may only be privately placed).

► Finally as far as the distributors' obligations are concerned, it is to be stressed that whatever the nature of the targeted investors or of the fund, distributors are always under an obligation to verify that the fund of hedge funds is suitable to the investor before recommending it. The suitability obligations upon funds of hedge funds' distributors are actually found in most SC5 member jurisdictions. Depending on the country, these obligations may either have a legal or regulatory ground (US-CFTC),[41] or derive from the

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[39] *See Wider-range Retail Investment Products: Consumer protection in a rapidly changing world – Feedback on DP05/3*, *supra* note 9.

[40] An accredited investor is defined as, among other things: (i) a natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his/her purchase of the fund of hedge funds' shares exceeds $1,000,000; and (ii) a natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

[41] Whereas in the securities industry, suitability rules require that investment advice be appropriate for the particular customer, the US-CFTC applies a "know your customer" rule, which requires that firms and

industry's practice or professional rules (*e.g.*, Canada Ontario, Canada Quebec). It is noteworthy that as far as the European jurisdictions are concerned, they are bound to subject the offer of financial products (including investment funds) to suitability tests pursuant to the European MiFID,[42] which was to be implemented in all EU Member States by 1 November 2007.

IV.3 The regulation of the funds of hedge funds' managers/advisers[43]

General overview of the regulation of the funds of hedge funds' managers/advisers

In most of the SC5 member jurisdictions, the managers/advisers of funds of hedge funds are subject to the same rules as those imposed upon traditional funds' managers. Such rules mainly require their prior registration with/licensing by the competent regulator (*e.g.*, Australia, Brazil, Canada Ontario, Canada Quebec, Germany, Hong Kong, Ireland, Italy, Japan, Luxembourg, the Netherlands, Portugal, Spain, Switzerland, the US). Generally, a fund's manager/adviser will have to meet certain requirements for the purposes of being registered or licensed (e.g., capital requirements, proficiency standards, professional liability insurance, educational requirements, experience and expertise requirements, human and technical resources).

In addition to the general rules on funds' managers, some SC5 member jurisdictions require funds of hedge funds' managers/advisers to satisfy conditions (such as the establishment of adequate risk control procedures, an amount of assets under management in excess of US$ 100 million).

A few SC5 member jurisdictions do have specific regulation on funds of hedge funds' managers/advisers such as Jersey (provided the manager/adviser is based in Jersey) or the UK (where funds of hedge funds are listed closed-ended funds, the UK applicable listing rules will apply).

The due diligence process

By way of introduction, the due diligence to be performed by a fund of hedge funds' manager/adviser could be defined as the thorough review and analysis of the main characteristics of a hedge fund prior to any investment into it and during such investment. **Globally, the legal/regulatory framework of most of the SC5 member jurisdictions does not require the execution of a due diligence process by funds of hedge funds' managers/advisers**. Generally, some due diligence is nevertheless carried out by managers/advisers as a result of the industry's common practice (*e.g.*, Luxembourg, Mexico) or on the ground of the managers'/advisers' duties towards the investors and regulators, whether such duties are legal, regulatory, fiduciary (*e.g.*, standards of care), ethical or else derive from rules established by self-regulatory organizations or professional associations

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brokers obtain sufficient information to assure most investors are adequately informed of the risks involved.

42 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.

43 For the purposes of this report, the terms "adviser" and "manager" shall both mean a person or entity which manages all or a specific portion of the fund of hedge funds' assets.

(*e.g.*, Australia, Brazil, Canada Ontario, Canada Quebec, Italy, Japan, US). The nature and frequency of the due diligence carried out therefore differs from one country to the other and from one manager/adviser to the other.[44]

A few jurisdictions do nonetheless legally require that managers/advisers effect due diligence before and during investments into underlying hedge funds (*e.g.*, Hong Kong and France where managers/advisers have to submit to the regulator a due diligence program for the selection and on-going monitoring of underlying hedge funds and to undertake to comply with such program at all times, Germany where managers/advisers must have in hands different information in relation to the targeted funds prior to any investment, Ireland where managers/advisers have to submit to the regulator detailed information on the controls and systems in place to monitor constantly the activities of the underlying hedge funds, their managers/advisers and risk assessment procedures as well as a detailed report upon request on the risk profile and recent performance of the fund of hedge funds' investments, Spain where the assessment and analysis procedures have to be expressly agreed upon between the management companies and the depositaries).

In these jurisdictions expressly providing for a due diligence process by the managers/advisers, the controls relate in particular to:

- the quantitative and qualitative assessment of the underlying hedge funds (notably as regards their investment policy and strategy, liquidity, leverage, investment restrictions, etc.);

- the assessment of the hedge funds' managers/advisers (organization, management, human resources, strategies and processes of investment, processes for building the portfolio, skills, education, risk management and control procedures (notably in the case of extreme situations), experience);

- the quality of service providers or counterparties (such as administrators, valuation agents, brokers, prime brokers, depositaries, etc.) and the conditions of delegation if any;

- the dissemination of information by the underlying funds (nature of the information, periodicity of delivery, periodicity of meetings between the investing fund's and the underlying fund's respective managers/advisers);

- the subscription and redemption conditions;

- the fees and expenses of the underlying hedge funds;

- the valuation procedures (valuation of the assets contained in the underlying hedge funds' portfolio and calculation of their net asset value);

- forms, registration and custody of the underlying hedge funds' units or shares;

[44] For instance, in Brazil, an underlying hedge fund may in practice, if its administrator finds it necessary, delay the disclosure of the composition of its portfolio to its investors (including funds of hedge funds) for a maximum period of 90 days.

- the legal documentation (such as the underlying funds' prospectuses and other incorporation documents, delegation agreements);

- the existence of side letters if any.

Consequently, managers/advisers operating in these jurisdictions are expected to actually receive different types of information in relation to the underlying hedge funds such as their latest annual and interim financial reports (*e.g.*, half-yearly and/or quarterly reports which may include performance and risks measurements, and show illiquid holdings), and their prospectuses. Such information has to be updated for the managers/advisers to be in a position to reassess the funds of hedge funds' characteristics on a regular basis (which should not exceed one year).

As regards the outsourcing of the due diligence process to third parties, only one country (Spain) expressly indicates authorizing such practice subject to some conditions.

It is also noteworthy that the provisions on the due diligence process to be implemented by managers/advisers (whatever the ground) do not clearly make a distinction between the due diligence prior to and the one after the investment into the underlying funds.

V. The Main Issues Relating to Funds of Hedge Funds as Identified with the Help of Industry Representatives

V.1 An overview of the responses received to the public consultation of April-July 2007[45]

The main comments of the respondents to the public consultation may be summarized as follows:

With regard to the information to be provided to investors

Generally, the respondents agree that **the information to be provided to investors should be understandable and useful** for them to decide whether or not to invest or redeem their investment. The information should therefore be **suitably detailed**. The key point (as raised by a respondent) is that the information delivered to retail investors be meaningful to them so that the investors know exactly what they are buying.

Hence, most respondents suggest that it is not relevant nor useful that the information disseminated to investors be too detailed.[46] It is for instance, proposed that the information on the hedge funds' risk management organization particularly relate to the funds' risk/return objectives and the regulated status of the investment manager or include details on the worst drawdown, the period of occurrence, as well as information on geographic, sector and asset class exposures and a scenario on potential worst case loss. It is further proposed that the information pertaining to the fund of hedge funds' strategy include for instance, information as to whether it is directional or not, the expected return, the expected volatility, the underlying risk, the nature of the underlying funds, the weighting of the allocation of capital across the different strategies.

Having said that, it is noteworthy that some respondents further suggest as regards the on-going information to be delivered to funds of hedge funds' unitholders or shareholders, that they receive the same information as the information delivered to unitholders/shareholders of "classical" funds such as multi-manager collective investment vehicles or UCITS, and in particular, the periodic financial statements.

A respondent proposes that information on the portfolio composition of underlying hedge funds be given to investors upon their request and within the same frequency as for financial statements.

As regards the periodicity of the information delivered to investors, one respondent further indicates that while it could normally be expected from investors to receive information on a monthly, quarterly, semi-annual and annual basis, the on-going information to be delivered to investors should not be prescribed in a set format on the ground that it is mostly commercial consideration between the promoter and the end clients. In the same way, a respondent considers that the promotion of disclosure standards should be addressed by the industry rather than by regulators.

[45] *See* IOSCO Consultation Document *supra* note 2.

[46] Most respondents consider that the provision of further detailed information to retail investors (such as the names of the underlying funds or of their managers) would not necessarily be helpful.

With regard to the potential conflicts of interests arising from fee sharing agreements between the bottom-tier fund and the top-tier fund

One respondent considers that any fee sharing agreement should be disclosed to investors in the fund's offer document and regular client reporting. Another respondent suggests referring to the MiFID rules for the purposes of dealing with potential conflicts of interests.

With regard to the selection of the underlying hedge funds

Two respondents suggest using a principles-based approach (implying the carrying out of a due diligence process by the investment manager) as opposed to an approach based on strict eligibility criteria which can often prove too inflexible and counterproductive (for instance, the criteria relating to the independence of the custodian, the relevant experience of the underlying funds' managers).

These respondents nevertheless subject the implementation of a principles-based approach to the conditions that the underlying hedge funds' managers be regulated entities and/or that the investment managers' set of due diligence be approved and regularly monitored by regulators. The due diligence set should be in line with that already existing for managers offering products to retail investors. It should in particular consist of an assessment of the underlying funds' legal structure, an assessment of the human and technological abilities of the underlying funds' managers, and an assessment of the underlying funds' strategy, risk management and valuation process.

On the contrary, one respondent considers that the provision of eligibility criteria is the most appropriate regulatory approach for the selection of underlying hedge funds. This respondent believes that common eligible criteria constitute a more objective set of rules for funds of hedge funds' managers and help setting up a common regime not subject to different national legal interpretations of the "due diligence". Such criteria also represent a more effective protection for retail investors.

With regard to the use of target performance by funds of hedge funds

A respondent considers that the use of target performance by funds of hedge funds and the question of the determination of a relevant benchmark are issues requiring further discussion. This respondent stresses that the use of risks ratios (*e.g.*, Sharpe ratio, etc.) or the comparison with alternative indices are not satisfactory solutions.

On the other hand, another respondent indicates that even though retail investors are not familiar with the concepts of expected outperformance, they should be encouraged to become familiar with them instead of receiving no information at all. This respondent suggests that funds of hedge funds be benchmarked against cash (unless the fund is specifically equitised), as cash benchmarks tend to reflect central banks base rates which are relatively understandable concepts for retail investors.

Finally, another respondent states the opinion that the determination of a fund of hedge funds' benchmark or target performance should be a matter for the fund of hedge funds' manager to decide.

With regard to funds of hedge funds' fees and in particular, the potential multiplicity of fee layers

Two respondents consider that it is important to ensure that investors have clear and sufficient information on the whole fees at the fund of hedge funds' level, in particular for them to understand the existence of fee layers. In this regard, a respondent notes that a complete disclosure of the underlying funds' fees is not realistic from an operational standpoint. Another respondent also supports a full disclosure of the fees received directly by the fund of hedge funds' manager and in which the manager has an economic interest (*e.g.*, in the case of associated underlying funds' managers).
Finally, a respondent suggests referring to the MiFID rules as far as the regulation of the transparency of fees, commissions or non-monetary benefits paid to the fund of hedge funds' manager is concerned.

With regard to the limits or conditions to be set up for the purposes of diversification

One respondent considers that the diversification issue depends on the nature of the investors. In the case of sophisticated investors, a low diversification would be acceptable provided it is clearly disclosed along with the strategy and the risks. No regulatory limit should therefore be necessary in this case. As regards retail investors, it is proposed to require around 10 underlying funds on the basis of recent studies. However, this respondent also stresses that it shall be ensured that the implementation of diversification rules do not entail over-diversification which would be risky for retail oriented funds of hedge funds in terms of supervision and monitoring of the various underlying funds.
Another respondent suggests imposing upon funds of hedge funds two minimum levels of diversification and concentration: (i) a fund of hedge funds should neither directly nor indirectly invest more than 10% of its total assets in a single fund; and (ii) the fund of hedge funds should not invest more than 25% of its total assets into funds that are managed by its manager or by entities belonging to the same group as that of the fund of hedge funds' manager.
Finally, a respondent does not believe that regulators should recommend or require minimum levels of diversification as depending on the cases, they could lead to a misunderstanding of the underlying risk. It further considers that there should only be some guidelines as to diversification by manager, style, sector, to be disclosed in the fund's offering and marketing documents.

With regard to the funds of hedge funds' liquidity and the potential issues for retail investors

Two respondents consider that the management of the fund of hedge funds' liquidity is essentially a market issue rather than one for regulatory interference. Funds of hedge funds' managers ought therefore to be free to establish liquidity levels such as lock-up periods.

Two respondents acknowledge that it is likely to be more important to a retail investor that the retail investor should be able to redeem his investment within a short time frame. The respondents therefore suggest that the operation of redemption gates be carefully considered particularly in the retail environment. It is in particular recommended that the use of "gates" be made in exceptional circumstances only for the purposes of protecting the interests of unitholders/shareholders who remain invested in the fund in the case of major redemptions.

With regard to the fund of hedge funds' valuation

Two respondents consider that the best solution to deal with valuation issues (which include timeliness of the underlying hedge funds' valuations and the use of estimates) would be for the fund of hedge funds' manager to establish an appropriate policy for the particular circumstances. Imposing a valuation frequency for the valuation of the underlying hedge funds would therefore not be relevant[47] as valuation issues depend on the strategies employed by the underlying hedge funds. According to these respondents, it is unlikely that there be a single appropriate regulatory position.

In this respect, the respondents also point out that in practice, the industry has found a number of acceptable mechanisms in particular for handling timing mismatches issues including the use of estimates, delayed payments, lock-up periods and liquidity limitations. A respondent however notes that the industry seems to be converging towards monthly valuations which would seem a sensible minimum.

Following another route, a respondent considers that funds of hedge funds should calculate their net asset values monthly and that it would be appropriate to require or recommend a monthly valuation of the underlying hedge funds. Moreover, for the purposes of addressing the use of estimated net asset values, it is suggested that funds of hedge funds pay immediately only 90% of their provisional net asset values and pay the remainder once the net asset values are finalized. Furthermore, it is proposed that funds of hedge funds' managers be allowed to calculate the funds' net asset values by proceeding to the valuation of the underlying funds' units on the basis of alternative and objective criteria.

As regards the due diligence relating to the underlying funds' net asset value calculation, a respondent recommends that the minimum measures include the use of the AIMA due diligence questionnaires covering individual hedge funds, funds of hedge funds, and administrators, on-site visit to the administrator, an understanding of how the administrator receives the information from the manager and prime broker, a demonstration that this is being cross-checked and matched independently, and that the administrator has independent access to financial feedlines for pricing instruments or assets.

With regard to the use of leverage by funds of hedge funds

A respondent considers that the use of leverage is not a specific issue to funds of hedge funds and should be considered in the course of a larger consultation including notably fund managers and prime brokers.

Two respondents consider that the use of leverage by funds of hedge funds cannot be addressed through regulations setting for instance some maximum levels, as the use of gearing depends on the specific context of the hedge funds and of their strategies. More particularly, one respondent believes that funds of hedge funds should be encouraged to disclose whether they are employing leverage at the funds of hedge funds' level, how they are gaining that leverage and what controls they employ to manage it. Another respondent considers that the use of borrowing by funds of hedge funds should be limited to the short term.

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[47] One respondent refers in this regard to the Alternative Investment Management Association's ("AIMA") Guide to Sound Practices for Hedge Fund Valuation (March 2007).

With regard to the sale of funds of hedge funds to retail investors

Two respondents believe that the appropriate standards to be implemented to consider the suitability of funds of hedge funds to retail investors are those found in the MiFID. One respondent further considers that the sale of funds of hedge funds to retail investors should be subject to the disclosure of risk warnings concerning in particular the use of leverage in derivatives.

With regard to the best practices on the due diligence to be performed by funds of hedge funds' investment managers

One respondent suggests that the best practices in this respect should rely on those developed by the AIMA and other trade associations.

Another respondent believes that the determination of the due diligence should only result from the contractual obligations specified in the management agreement.

Finally, a respondent believes there is no difference between the due diligence and the management skills used as regards a fund of hedge funds' investment process and those applied to the construction of any other multi-manager fund.

With regard to the level of transparency that should be required from the underlying funds for funds of hedge funds' managers to conduct their due diligence appropriately

One respondent considers that the level of transparency required to conduct adequate diligence is dependent on the characteristics of the underlying funds. In this respect, this respondent would recommend at least an information on the monthly performance of all underlying hedge funds, indicative exposure numbers (*e.g.*, leverage, volatility, Sharpe ratio), and an annual visit to underlying funds to review operations, service providers including a full review of the Disaster Recovery and Business Continuity arrangements. This respondent considers that the information to investors could be limited to high level information (to give them a feel for where the risk is being taken) as they are delegating responsibility to the skill of the funds of hedge funds' managers and are paying fees for that service.

Another respondent considers that the level of transparency to be required from the underlying funds should be as defined in the agreement between the fund of hedge funds' manager and the underlying hedge funds' managers.

With regard to the use of side letters

One respondent strongly believes that where a side letter contains a material term which might be seen as putting an investor at a disadvantage, then the existence of such letter may be made known to all affected investors.[48]

48 In this respect, the respondent refers to AIMA's Industry Guidance Note on Side Letters of 27 September 2006 and Supplement n° 1 thereto dated 24 October 2006.

On the contrary, another respondent believes that the use of side letters should be banned for funds of hedge funds sold to retail investors on the ground that such practice is of little relevance for the industry and entails the risk of unfair treatment of these investors.

With regard to delegation

The majority of respondents support the delegation and other forms of outsourcing in relation to funds of hedge funds. According to one respondent, the delegation of the fund of hedge funds' functions could relate to the operational due diligence (in this case, the delegatees would be lawyers or auditors) and the financial management (in this case, the delegatees would be regulated managers only).

A respondent stresses in particular that there is no reason to prohibit the use of delegation so long as it is transparently revealed and appropriate levels of due diligence have been undertaken to determine the quality of the provider.

Another respondent suggests that the delegation should be made under similar conditions to those provided for in the UCITS Directive.

V.2 An overview of the comments made by experts from the funds of hedge funds' industry worldwide[49]

By way of introduction and for their report to be as close as possible to the industry's operational practice, the SC5 members organized three hearings[50] for the purposes of exchanging views with US, European and Asian market practitioners on the scope of the relevant issues to be addressed by IOSCO on funds of hedge funds. The conclusions of the hearings do complete those conclusions resulting from the responses to the IOSCO Consultation Document.[51]

The conclusions of the hearings may be summarized as follows:

► **From a general perspective**, the experts considered that the IOSCO Consultation Document addressed the whole scope of the relevant issues that might be tackled from a regulatory point of view. Hence, no significant issue had been omitted by the IOSCO Consultation Document.

The experts further stated that in their opinion, the determination and implementation in the different jurisdictions of high level rules pertaining to funds of hedge funds was in the interests of investors as opposed to the application of fragmented regulations from one jurisdiction to another.

The experts also described the funds of hedge funds' market as being rather safe and stable. For the purpose of illustration, a special focus was made on European funds of hedge funds

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49 The names of the experts who participated to the hearings are listed in Appendix 3 to this Report.

50 A hearing in the US with American experts was held in Washington, DC; a hearing in Europe with European experts was held in Paris; and a hearing in Asia with Asian experts was held in Hong Kong.

51 *See* IOSCO Consultation Document *supra* note 2.

which have to have an independent valuation agent and an independent custodian. The Asian experts further mentioned as an example, the stabilization of hedge funds fees generally.

► The European and Asian experts further indicated that there was no point in limiting from a regulatory standpoint **the retail investors' access** to funds of hedge funds in consideration of the increasing popularity of these funds among retail investors, provided however specific conditions were satisfied (such as transparency). For the purpose of illustration, the experts noted that a few jurisdictions (such as Germany, France, Ireland and the UK) had already or were in the process of adapting their legal and regulatory framework with a view to allowing retail investment into funds of hedge funds. The experts also stressed that retail investors might already have direct access to hedge funds in different ways notably on many on-shore exchanges (such as the UK).

► **The experts identified the key risks** in relation to funds of hedge funds and provided preliminary views as to the way to address them:

(i) The risk of *misselling* funds of hedge funds:

This risk has been identified by the experts as being a major risk attached to funds of hedge funds as far as the liability of the manager and distributor is concerned. This is particularly true in the jurisdictions that do not authorize the distribution of funds of hedge funds to retail investors (*e.g.*, the US where funds of hedge funds' investors are exclusively sophisticated or wealthy investors, the UK).

In this regard, the experts stressed the **importance of the suitability and "know your customer" tests** to be carried out by any distributor of funds of hedge funds. For instance, the US-SEC requires every broker-dealer to ensure that the product it is selling is suitable for the client, whereas managers apply in practice a "*see-through*" approach when they sell their funds of hedge funds, that-is-to-say that they ensure that any client has actually received the relevant documentation (*e.g.*, subscription document, the offering document, etc.).

For the purpose of addressing the *misselling* risk, the US experts suggested that if it was contemplated to authorize retail investors to invest into funds of hedge funds, two conditions would have to be satisfied:

- a definition of retail investors (and a clear borderline with "sophisticated investors") would have to be provided beforehand which might be a tricky matter considering the various definitions currently existing;

- the funds of hedge funds would have to be structured in a way to fit retail investors' profiles, needs and experiences.

Interestingly, a few European experts indicated that the question of transparency toward investors was in practice more a theoretical question than a real issue given that in practice, investors are demanding more and more disclosure so that funds of hedge funds' managers are used to providing regular reporting elaborated in order to meet the clients' requirements. Moreover, experience shows that the reporting on the investment management is basically the same for all categories of investors (whether institutional or retail), the only difference between institutional and retail clients being that institutional clients are requesting more detailed information. Hence, retail investors generally benefit from the investment of institutional investors into funds of hedge funds as the latter are more demanding as far as disclosure is concerned.

As regards the **nature of the information owed to be disclosed to investors**, if the European experts specified that an extensive reporting to the clients was not useful and that the level of transparency largely depended on the investment strategy implemented by the funds' underlying hedge funds, the experts nonetheless globally acknowledged and recommended that investors should at least receive a clear and non misleading description in relation to:

- the funds of hedge funds' risk/return, investment strategy and portfolio breakdown;

- the underlying hedge funds' strategies;

- the reference currency of the funds of hedge funds' net asset value (in particular where the funds of hedge funds have several share classes denominated in various currencies);

- the funds of hedge funds' fees. It is noteworthy that the experts recommended that the presentation of such fees (in particular, the "total expense ratio" or "TER") should be harmonized throughout the world[52] from one country to the other and that any fee rebate whatsoever be clearly disclosed to the investors. A few experts nonetheless acknowledged that in the world of funds of hedge funds, fee retrocession on the part of the underlying funds was not a common practice as opposed to traditional funds of funds;

- the use of side-letters. The experts generally agreed that the use of such side-letters should be limited and that any such use should always be disclosed to the investors, even if such a disclosure might raise concerns.

It is worthy of note that the experts also globally considered that the disclosure of the underlying hedge funds' names (as opposed to the said funds' strategies) or of the underlying hedge funds which were divested from by the funds of hedge funds was not relevant to retail investors and would further be detrimental to the underlying hedge funds' managers.

(ii) The *liquidity* risk:

The experts agreed that this risk mainly related to the gap between the maturity of a fund of hedge funds' units and that of the units of the underlying hedge funds which might largely invest in illiquid assets. The experts stressed that the liquidity risk also raised the question of the correlation of the underlying funds' strategies and more globally the issue of the diversification of the underlying funds. At this stage, no standard appears to fit this diversification issue.

[52] Such a harmonization would be a delicate exercise due to the aggregation of the various performance fees of the underlying hedge funds.

For the purposes of addressing the liquidity risk, the experts suggested several actions including:

- the provision of a regulatory requirement that there be a real consistency between the liquidity of the funds of hedge funds and that of the underlying hedge funds;

- the implementation of a lock up mechanism (provided it is in the interests of the investors as the practice shows that a few hedge funds' managers have had a tendency to increase the duration of the funds' lock up periods);

- the use of "gates" which threshold consists of a percentage pertaining to the investment of every unitholder (for example, the authorization of a maximum redemption of 25% of each unitholder's investment every quarter) as opposed to a percentage pertaining to the fund of hedge funds' portfolio which would not solve the issue and would further be detrimental to unitholders (for instance, the authorization of a maximum redemption of 25% of the fund's portfolio every quarter);

- the limitation of funds of hedge funds' investments into underlying hedge funds holding illiquid assets.

A few experts stressed that the funds of hedge funds' liquidity was not always an issue on the ground that a limited liquidity might be a means to protect retail investors' interests (for instance, in the event of a crisis where the financial instruments concerned could not be appropriately valued and could as a result only be sold at an undervalued price). In addition, in certain circumstances, funds of hedge funds could not be in a position to invest the investors' subscription monies into underlying funds due to capacity problems.

(iii) The *valuation* risk:

The experts agreed that this risk was quite important especially as the underlying hedge funds did not always provide for the relevant and adequate valuation information to the investing funds of hedge funds. The experts noted that the major risks related to valuation concerned:

- the potential liquidity mismatch between the redemption terms of the funds of hedge funds, and those of the underlying hedge funds;

- the valuation periodicity; and

- the independence of the valuation agents.

For the purposes of addressing the valuation risk and of protecting the remaining investors' interests, the experts suggested the following:

- not to invest into any asset that could not potentially be priced and/or for which it would not be clear how it was priced;

- to prohibit the payment of all redemptions monies on the basis of the estimated net asset value (for instance by allowing deferred payments).

It is noteworthy that one expert suggested that the underlying hedge funds and the investment management companies that manage the underlying hedge funds have different external auditors.

<u>(iv) The *operational/fraudulent* risk related to the underlying funds:</u>

The experts indicated that an important issue as regards funds of hedge funds related to the funds' service providers and in particular, the entities responsible for holding the assets of the funds in custody. They added that a key question was "who holds the cash at the underlying hedge funds' level?"

The experts stressed that the due diligence process to be carried out by funds of hedge funds' managers was therefore a key step as far as management was concerned. The experts specified that such a due diligence process had a two-fold objective:

- the **selection** of the underlying hedge funds;

- the **constant monitoring** of the selected underlying hedge funds (in particular, as regards the consistency of their characteristics). The due diligence process could actually be described as **a constant dialogue** with the underlying hedge funds' investment managers.

The experts further emphasized that the main purposes of such a due diligence process was for the funds of hedge funds' managers to understand the operations of the underlying hedge funds and to adequately tackle the key questions such as for instance, the status of the person/entity who controls the cash and who can deal with redemption requests, the level of independence between the administrator and the manager of the underlying hedge funds, the underlying funds' risk exposures (*e.g.*, by investment strategy, asset class, geographical market) and risk controls, and the turnover of the underlying funds' portfolio managers. For all these reasons, the selection of an underlying hedge fund and its monitoring necessarily are lengthy processes.

The experts also underlined that **for the due diligence process to be efficient, it had to be simple, straightforward and complied with at all times**. The experts added that it also required that the funds of hedge funds' managers be endowed with a proper organization.

The experts identified some obstacles to the performance of a thorough due diligence notably:

- the poor level of disclosure of certain hedge funds: the experts stressed that the performance of the due diligence by the funds of hedge funds' managers was closely linked to the level of disclosure made by the underlying funds. Hence, the less a fund of hedge funds' manager has access to an underlying hedge fund, the more due diligence he has to carry out;

- the young age of hedge funds globally (*i.e.*, less than three years old) which are therefore not in a position to provide for a long track record. A few experts explained that this obstacle was closely linked to the development of more and more "boutique houses" on the hedge fund market.

The experts nonetheless noted that in practice, the implementation of the due diligence process by the funds of hedge funds' managers was usually easy as the underlying hedge funds' managers were generally expecting questions and were therefore ready and willing to answer such questions. The Asian experts specified that in some cases, the level of disclosure made by the underlying hedge funds could be linked to the duration of the investment of the funds of hedge funds.

Finally and interestingly, the majority of the experts indicated that they carried out **their due diligence "in-house"** so that the outsourcing of due diligence did not appear to be the most common practice.

<u>(v) The other issues:</u>

It is noteworthy that a few experts raised some additional issues regarding funds of hedge funds and in particular **cross-border regulation** (due to the lack of harmonization of the funds of hedge funds' regulations in force in the different jurisdictions) and **the level playing field issue between competing financial products** (a few experts noted the emergence of marketing materials advertising for funds "replicating" a fund of hedge funds. These experts considered such marketing materials to be most misleading as the investment management technique/strategy used by such funds was unclear, so were the risks attached thereto).

* * *

VI. Conclusion: IOSCO's Future Work

Globally, this Report **confirms** the observations made and **the related investor protection regulatory issues emphasized in the IOSCO 2003 Report**.[53]

This Report also points out that **funds of hedge funds are largely regulated or authorized** in the majority of SC5 jurisdictions, the applicable rules being generally based on the regime for traditional collective investment schemes as potentially completed by specific rules. Interestingly, this Report shows that in some cases, there is a true convergence of the national rules developed and implemented by the SC5 jurisdictions, notably in respect of disclosure to investors prior to and after their investments (particularly as regards the investment strategies and the related risks), the eligibility criteria requirement for selecting underlying hedge funds (even if such criteria may be different from one jurisdiction to the other), and the possibility to offer funds of hedge funds to retail investors subject to conditions or sales restrictions.

Nonetheless, this Report highlights that a few areas are either lightly regulated if not unregulated, or too generally regulated, which could raise concerns for regulators in consideration of the increased participation of retail investors in funds of hedge funds over the last years. Indeed, this Report identifies **additional investor protection regulatory issues**, and in particular, the liquidity risk and the operational and fraudulent risk of the underlying hedge funds notably as regards the absence of any general requirement relating to the performance of a due diligence by funds of hedge funds' managers (which implies that there is no common understanding as to the nature and conditions of the managers' due diligence process).

In consideration of the above, further work might therefore be useful to determine whether guidelines are needed in the particular areas to complete those provided for by the IOSCO 2003 Report. In this regard, it could be envisaged to consider the potential development of "*elements of international regulatory standards on funds of hedge funds*" based on best market practices in relation to:

- the methods that may be utilized by funds of hedge funds' managers in order to deal with the **liquidity** risk (*e.g.*, the conditions for setting up lock-up periods, redemption suspension, redemption gates, deferral of redemption requests, side letters);

- the **nature and the conditions of the due diligence** process by funds of hedge funds' managers prior to and during investment. In this respect, it could be contemplated to consider in particular:

    - the elements to be constantly monitored and analyzed by managers (such as the underlying hedge funds' legal regime, organization and valuation (*e.g.*, the valuation method used, its compliance with international standards…);

[53] The IOSCO 2003 Report provides that the two key regulatory concerns raised by the retail investment into hedge funds or funds of hedge funds relate to (i) information disclosure for the retail investor to adequately understand the risks involved in or the complexity of the product, and (ii) the competence or the processes and controls of the manager. The IOSCO 2003 Report stresses that issues specific to funds of hedge funds relate to the disclosure to investors of information on underlying funds and how they are selected, the manager's due diligence on underlying funds, diversification of the fund of hedge funds' investments, "double" fees, and investment activity at fund-of-funds level.

- the resources, procedures and organizational structures that funds of hedge funds' managers could be required to have for the purpose of carrying out a proper and robust due diligence; and

- the conditions for authorizing the outsourcing of due diligence.

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Appendix 1

SC5 Questionnaire on Funds of Hedge Funds

I. Funds of Hedge Funds' Questionnaire: an Overview

1. **Does your legal/regulatory framework provide for a definition of FoHFs? If yes, please provide your definition.**

2. **Please provide an estimate of the number of FoHFs in your jurisdiction and of the global amount of assets under management by these FoHFs.** If relevant, please specify whether your figures cover FoHFs domiciled in your country, FoHFs the manager/adviser of which are domiciled in your country, or both.

3. **How are funds of hedge funds typically organized in your jurisdiction?**

II. Regulation of FoHFs:

II.1. With regard to the FoHF:

4. **Does your jurisdiction regulate or authorise the FoHF itself? Does it require "registration" of FoHFs?**

5. **If FoHFs are regulated in your jurisdiction, do they fall under:**
    a) the normal legal/regulatory/statutory framework applicable to collective investment schemes ("CIS"); or
    b) a specific legal/regulatory/statutory regime?

If 'b', please specify.

6. **If FoHFs are <u>not</u> regulated in your jurisdiction, please indicate whether this is due to the fact that they are:**
    a) prohibited; or
    b) exempted.

If 'b', please briefly specify the nature of the exemption (legal/regulatory/statutory/customary) and the criteria used to determine the applicability of the exemption.

7. **How does your jurisdiction regulate or authorise FoHFs?** Please describe the main restrictions applicable to a FoHF's activities – leverage, short selling, derivatives, minimum number of underlying funds, etc.-.

8. **Does your legal/regulatory framework provide for or authorise lock-up periods for FoHFs? Are there any specific circumstances where redemptions may be suspended/postponed? If, yes, please specify.**

9. **Does your legal/regulatory framework provide for eligibility criteria to be met by the underlying hedge funds into which a FoHF is investing? If yes, please provide the list of these criteria.**
10. **Do investment restrictions differ between domestic and foreign target funds? If yes, please describe.**

11. **To what degree may FoHFs employ leverage and invest in other assets apart from target single hedge funds?**

12. **Pursuant to your legal/regulatory framework, can FoHFs be offered to retail investors? If conditions have to be met, what are these legal/regulatory conditions?**

13. **In your jurisdiction, are there any rules governing the payment of rebate commissions by the underlying hedge funds to a FoHF? If yes, what are they? Are these rules specific to FoHFs or are they consistent with the general rules applicable to CIS?**

II.2. With regard to the FoHF's Manager/Adviser:

14. **Does your jurisdiction regulate Managers/Advisers of FoHFs? If yes, do Advisers/Managers have to be registered or do they merely have to meet certain requirements for the purposes of managing FoHFs,** e.g., educational experience, professional degrees, specific licenses, no fraud convictions in the last 10 years, etc.?

15. **Does your legal/regulatory framework require that a due diligence process be made by the FoHF's Manager/Adviser before any investment in the underlying hedge funds? If yes, please describe the main features of the due diligence process to be carried out by the FoHF's Manager/Adviser (e.g., types of controls, etc.). In which cases would a FoHF's Manager/Adviser be deemed responsible?** Please, detail your answer.

16. **In this regard, what information (nature, content and frequency) is required/expected by the FoHF's Manager/Adviser from the underlying hedge funds and their related parties?**

II.3. Sales restrictions:

17. **Are there any limitations or restrictions on the sale of FoHFs' units/shares to retail investors/general public which the relevant selling entity or person (e.g., broker/dealers, distributors) are required to follow?** For instance, does your jurisdiction impose investor "net worth" requirements, minimum investment amounts requirements, only permitted investments in FoHFs, liquidity or redemption obligations?

III. <u>Retail FoHFs' Disclosure/Reporting:</u>

18. **Does your jurisdiction require FoHFs to disclose the main investment strategy in which they are invested in (e.g., global macro, event-driven...)?** Or do FoHFs only have to indicate that they are globally invested in all alternative strategies?

19. **Does your jurisdiction require FoHFs to publish a NAV? If yes, is there a minimum frequency required (weekly, monthly,...)?**

20. **Is the use of the estimated NAVs of the underlying hedge funds acceptable/authorised in your legal/regulatory framework for the purposes of calculating FoHFs' NAVs? Are there any specific limits in relation to the use of such estimated NAVs?**

21. **Does your jurisdiction require FoHFs to provide retail investors with an offering memorandum?** If yes, what are the main provisions required to be mentioned in the offering memorandum?

22. **Once an investor has purchased the units/shares of a FoHF, what information has to be delivered to him on an ongoing basis and how frequently?** For example, as regards the information on the composition, concentration, leverage and the performance of the FoHF's portfolio.

23. **Is the use of side letters a common practice in your jurisdiction? If yes, what kind of concerns do side letters raise for FoHFs? How does your jurisdiction handle them?**

* * *

Appendix 2

Feedback Statement on the Public Comments Received on the *Call for Views on Issues that Could be Addressed by IOSCO on Funds of Hedge Funds,* April 2007

Introduction

1. In April 2007, the Technical Committee of IOSCO published a "*Call for Views on Issues that Could be Addressed by IOSCO on Funds of Hedge Funds*" ("IOSCO Consultation Document").[54] The deadline for comments on the IOSCO Consultation Document was 20 July 2007.

2. The IOSCO Consultation Document maps the different approaches taken in each SC5 member jurisdiction with regard to funds of hedge funds. The report complements the previous work undertaken by IOSCO on the same subject in a February 2003 report entitled, *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds*[55] and in a November 2006 report entitled, *The Regulatory Environment for Hedge Funds: A Survey and Comparison.*[56] Its purpose is to identify the specific regulatory issues arising from funds of hedge funds and in particular those being retail oriented.

Responses (General)

3. Comments were received from four organizations in response to the IOSCO Consultation Document. SC5 met in Hong Kong on 27-28 November 2007 to consider the comments.

4. From a general standpoint, the respondents to the public consultation welcome IOSCO's work on funds of hedge funds and in particular, the consultation launched in April 2007. They particularly support the idea that retail investors should, subject to appropriate protection rules, be allowed access to the alternative investment arena through funds of hedge funds. Some responses raised particular technical issues that have been incorporated into the final report. The general feedback statement presenting the main issues raised by the respondents can be found in section V.1 of the report.

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54 *Call for Views on Issues that Could be Addressed by IOSCO on Funds of Hedge Funds*, Report of the Technical Committee of IOSCO, April 2007, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD244.pdf.

55 *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds*, Report of the Technical Committee of IOSCO, February 2003, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD142.pdf.

56 *The Regulatory Environment for Hedge Funds—A Survey and Comparison*, Final Report, Report of the Technical Committee of IOSCO, November 2006, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD226.pdf.

Responses (Specific)

5. The following chart reflects the specific comments made by the respondents to the IOSCO Consultation Document.

Organization	Specific comments
Alternative Investment Management Association Limited (AIMA)	- believes that a high level principles based approach relying on the adequate due diligence to be performed by the fund of hedge funds' manager is the correct way to go (as opposed to prescriptive or proscriptive rules and regulations (for instance as regards the selection of the underlying hedge funds)). The recommended approach implies that the fund of hedge funds be authorised and licensed to offer retail investments and that a set of high fiduciary standards be determined by regulators in line with those already existing for managers offering products to retail investors. - considers the appropriate level of disclosure to investors is an important issue to be considered by IOSCO (a right balance is vital for both the investors and funds of hedge funds' managers): while it believes that the information provided to retail investors (e.g., as regards risks, investment strategies) should be both meaningful and understandable (for them to decide whether or not to invest or redeem their investment), it considers that it should not be prescribed in a set format (as it is mostly commercial consideration between the promoter and end clients). The key point is that the information be clear so that the investor knows exactly what he is buying. - considers that any fee-sharing agreement should be disclosed to investors in the fund's offer document and regular client reporting. - supports the selection of underlying funds through a principles-based approach (due diligence) as opposed to the implementation of strict eligibility criteria. - suggests to use cash benchmarks to assess performance targets as these benchmarks tend to reflect central banks base rates which are relatively understandable concepts for retail investors (unless

Organization	Specific comments
	the fund is specifically equitised). - considers that information on fees delivered to investors should be sufficient for them to understand the existence of fee layers and to be fully aware of the fees received directly by the fund of hedge funds' manager and in which he has an economic interest (e.g., in the case of associated underlying funds' managers). - considers that the conditions and limits on diversification should be the object of recommendations as opposed to regulatory conditions (which could, depending on the cases, lead to a misunderstanding of the underlying risk). - considers that the management of the fund of hedge funds' liquidity is essentially a market issue rather than one for regulatory interference. Nevertheless, regulators should give careful consideration to the liquidity issue particularly in the retail environment. - considers that the best solution to deal with valuation issues (timeliness of the underlying hedge funds' valuations and the use of estimates) would be for the fund of hedge funds' manager to establish an appropriate policy for its particular circumstances. A reference is made to the AIMA's Guide to Sound Practices for Hedge Fund Valuation (March 2007). - considers that the use of leverage by funds of hedge funds cannot be addressed through regulations setting maximum levels: however, funds of hedge funds should be encouraged to disclose whether they are employing leverage at the funds of hedge funds' level, how they are gaining that leverage and what controls they employ to manage it. - considers that funds of hedge funds can be sold to retail investors provided the suitability rules under the MiFID are complied with and risk warnings are made concerning in particular the use of leverage in derivatives. - considers that there is no difference between the due diligence performed by the manager of a fund of hedge funds and that of a multi-manager fund. - considers that the level of transparency required to conduct adequate diligence is dependent on the characteristics of the underlying funds: it

Organization	Specific comments
	recommends at least an information on the monthly performance of all underlying hedge funds, indicative exposure numbers (e.g. leverage, volatility, Sharpe ratio), and an annual visit to underlying funds to review operations, service providers including a full review of Disaster Recovery and Business Continuity arrangements. The information to investors could be limited to high level information (to give them a feel for where the risk is being taken) as they are delegating responsibility to the skill of the fund of hedge funds' manager and are paying fees for that service). - strongly believes that where a side letter contains a material term which might be seen as putting an investor at a disadvantage, then the existence of such letter may be made known to all affected investors. In this respect, a specific reference is made to AIMA's Industry Guidance Note on Side Letters of 27 September 2006 and Supplement n° 1 thereto dated 24 October 2006. - considers that there is no reason to prohibit the use of delegation so long as it is transparently revealed and appropriate levels of due diligence have been undertaken to determine the quality of the provider. - supports mutual recognition between EU Member States of each other's nationally authorised non UCITS schemes including funds of hedge funds.
Association Française de la Gestion Financière (AFG – a French leading professional association for the investment management industry)	- believes two questions should be further discussed and considered within a wider scope than the funds of hedge funds': (i) the use of target performance and the definition of a relevant benchmark; (ii) the use of leverage. - proposes the setting up of an "alter UCITS" regime for funds of hedge funds (i.e., which would therefore be subject to lighter regulation and managed by managers able to monitor the risks). - believes investors of funds of hedge funds should receive the same information as that provided to investors of "classical funds" (for instance, no need to disclose the names of the underlying funds).

Organization	Specific comments
	- considers the selection of underlying funds should be made following a principles-based approach (a set of due diligence carried out by the manager and approved by regulators) as opposed to the application of eligibility criteria. - considers investors should receive information on fees at the fund of hedge funds' level. - considers that the minimum level of diversification depends on the nature of investors and that for retail funds of hedge funds, it should be around 10 underlying funds. - believes that gates may solve liquidity issues (relating to the asset/liability adequacy) in case of important redemptions provided they remain exceptional. - believes that imposing a valuation frequency for the underlying hedge funds is not relevant: this is a matter to be considered by the fund of hedge funds' manager. - considers that IOSCO should take into account AIMA's and other trade associations' best practices in relation to the due diligence by the fund of hedge funds' manager. - supports delegation of operational diligence and of financial management.
Assogestioni	- considers that the information provided to retail investors on the underlying hedge funds' investment strategies should be simple and easily understandable (for instance, in the form of periodic financial statements as for UCITS): the promotion of disclosure standards should be a matter to be addressed by the industry, not by regulators. - proposes that information on the portfolio composition of underlying hedge funds be given to investors upon their request and within the same frequency as for financial statements. - considers that the setting up of eligibility criteria is

Organization	Specific comments
	the most appropriate regulatory approach for the selection of underlying hedge funds: common eligible criteria constitute a more objective set of rules for fund of hedge funds' managers (and help setting up a common regime) and a more effective protection for retail investors. - believes that the determination of a fund of hedge funds' benchmark or target performance is a matter for the fund of hedge funds' manager to decide. - suggest to refer to the MiFID rules as far as regulation of fee transparency and conflicts of interests are concerned. - suggests imposing two minimum levels of diversification upon a fund of hedge funds: (i) it should neither directly nor indirectly invest more than 10% of its total assets in a single fund, and (ii) it should not invest more than 25% of its total assets into funds that are managed by its manager or by entities belonging to the same group as that of its manager. - considers that funds of hedge funds' managers ought to be free to establish liquidity levels (such as lock up periods of at least 1 month). - considers that funds of hedge funds should calculate their net asset values monthly and that it would be appropriate to require or recommend a monthly valuation of the underlying hedge funds. For the purposes of addressing the use of estimated net asset values, it is suggested that the fund of hedge funds pays immediately only 90% of its provisional net asset value and pays the remainder once the net asset value is finalized. Finally, it is proposed to allow funds of hedge funds' managers to calculate the funds' net asset values by proceeding to the valuation of the underlying funds' units on the basis of alternative criteria being objective. - believes that regulators should not promote particular standards to address leverage in the specific context of funds of hedge funds. - believes that the appropriate standards to be implemented to consider the suitability of funds of hedge funds to retail investors are those found in the

Organization	Specific comments
	MiFID. - believes that the determination of the due diligence to be performed by the fund of hedge funds' manager should only result from the contractual obligations specified in the management agreement. - considers that the level of transparency to be applied in relation to the underlying hedge funds should be as defined in the agreement between the fund of hedge funds' manager and the underlying hedge funds' managers. - believes that the use of side letters should be banned for funds of hedge funds sold to retail investors. - supports delegation of funds of hedge funds' functions: such delegation should be made under similar conditions to those provided for in the UCITS Directive. Further believes that a delegation of the fund's net asset value calculation to the depositary should be expressly allowed.
SEC Thailand	Raises two questions: - Should the investment in funds of hedge funds be allowed in jurisdictions where investment in hedge funds (the underlying funds) is not permitted? Pros/cons? - If the answer is yes, what criteria should be used for authorizing such investment, what should be the regulatory framework involved? This issue particularly concerns EMC jurisdictions.

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Appendix 3

Experts from the Funds of Hedge Funds' Industry
Who Participated in the Hearings Organized by SC5

<u>Hearing held in Washington, DC on 23 July 2007:</u>

- *Mr. David Kavanagh, Dearborn, Chicago;*
- *Mr. Stuart Pologe, Oppenheimer Funds, Tremont Group Holdings, Inc., New York; and*
- *Mr. Efim Tkatchew, Dearborn, Chicago.*

<u>Hearing held in Paris on 8 October 2007:</u>

- *Mr. Robert Aitken, Head of Compliance, MAN Investments, UK;*
- *Mr. Liam Butler, Bank of Ireland Securities Services, Ireland;*
- *Mr. Emmanuel Courant, Directeur Général Adjoint, Edmond de Rothschild Multimanagement, France;*
- *Mr. Luc De Vet, Member of the EU Expert Group on Hedge Funds and Managing Director of Citco, Luxembourg;*
- *Mr. Christopher Fawcett, Chairman of the AIMA and CEO and CIO of Fauchier Partners, UK;*
- *Mr. Clayton Heijman, AIMA, the Netherlands;*
- *Mr. Pierre-Yves Moix, Chief Risk Officer, MAN Investments, UK;*
- *Mr. Palasi, Chairman, Edmond de Rothschild Multimanagement, France; and*
- *Mr. Vert, Chairman, Allianz AAM, France.*

<u>Hearing held in Hong Kong on 27 November 2007:</u>

- *Ms. Eliza Lau, CEO & CIO of Sail Advisors Limited, Hong Kong;*
- *Mr. Stuart Leckie, President of Stirling Finance Limited, Hong Kong; and*
- *Ms. Liu Yang, Chairman of Atlantis Investment Management (H.K.) Limited, Hong Kong.*

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