Proposed Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices

Consultation Report

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

OCTOBER 2008

This paper is for public consultation purposes only. It has not been approved for any other purpose by the IOSCO Technical Committee or any of its members.

Foreword

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,[1] the IOSCO Technical Committee (TC) considered the particular regulatory issues arising from the investment of retail investors into hedge funds and described approaches for addressing the consequences of such issues upon retail investors. The report further underlined that funds of hedge funds are the primary vehicles used for attracting retail investment in the hedge fund area.

In light of the increasing interest of retail investors in funds of hedge funds, and of the legal and regulatory developments in the field in various jurisdictions, the TC decided in February 2007 to conduct further work with a view to assessing whether the regulatory principles provided in the aforementioned 2003 report needed to be amended and / or completed. The TC further decided that this work be focused on retail oriented funds of hedge funds.

For this purpose, the TC (acting through Standing Committee 5 on Investment Management) notably consulted in 2007 its member jurisdictions on the key features of their regulatory framework, and the international financial community through the publication of a *Call for Views on Issues that could be Addressed by IOSCO on Funds of Hedge Funds,*[2] and the holding of three hearings with funds of hedge funds' experts worldwide.

As a result thereof, the TC issued in June 2008 a *Report on Funds of Hedge Funds*[3] in which it proposed, after examining the prevailing regulations of funds of hedge funds in various jurisdictions, to develop guidelines in the two particular areas where it had identified additional investor protection regulatory issues namely:

(i) The methods by which funds of hedge funds' managers deal with liquidity risk; and
(ii) The nature and the conditions of the due diligence process to be carried out by funds of hedge funds' managers prior to and during investment.

Pursuant to the conclusions of its 2008 report, the TC (acting through Standing Committee 5 on Investment Management) therefore elaborated the herein *Proposed Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices,* and is hereby submitting them to the international financial community for the purpose of receiving comments in relation thereto.

Further to this consultation, the TC will issue a final version of the *Proposed Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices.*

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[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.

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

[3] *Report on Funds of Hedge Funds–Final Report*, Report of the Technical Committee of IOSCO, June 2008, available a http://www.iosco.org/library/pubdocs/pdf/IOSCOPD276.pdf.

How to Submit Comments

Comments may be submitted by one of the three following methods **<u>on or before 5 January 2009</u>**. To help us process and review your comments more efficiently, please use only one method.

1. E-mail

- Send comments to k.allen@iosco.org
- **The subject line of your message should indicate "Proposed Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices."**
- Please do not submit any attachments as HTML, GIF, TIFF, PIF or EXE files.

OR

2. Facsimile Transmission

Send a fax for the attention of Ms. Kim Allen, using the following fax number:
+ 34 (91) 555 93 68.

OR

3. Post

Send your comment letter to:

Ms. Kim Allen
IOSCO General Secretariat
C / Oquendo 12
28006 Madrid
Spain

Your comment letter should indicate prominently that it is a "Public Comment on Proposed Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices."

<u>Important</u>: All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

Proposed Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices

In the report on *Funds of Hedge Fund–Final Report*, dated June 2008[4] and for the purpose of completing the principles provided for in the report entitled *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds* as published in February 2003,[5] the IOSCO Technical Committee Standing Committee on Investment Management (SC5) has proposed to develop guidelines in the particular areas where it has identified additional investor protection regulatory issues in the fund of hedge funds field. These particular areas relate to:

I. The methods by which funds of hedge funds' managers deal with liquidity risk; and
II. The nature and the conditions of the due diligence process used by funds of hedge funds' managers prior to and during investment.

The following elements of international regulatory standards have therefore been developed:

I. The methods by which funds of hedge funds' managers deal with liquidity risk

I. 1 The fund of hedge funds' manager should make reasonable enquiries to enable it to consider whether the fund of hedge funds' liquidity and that of the underlying hedge funds are consistent.

In particular, the fund of hedge funds' manager should consider whether the level of the underlying hedge funds' liquidity is appropriate and sufficient for the fund of hedge funds to meet any redemption or repurchase obligation to its unitholders or shareholders upon their request.

I. 2 Before and during any investment, the fund of hedge funds' manager should consider the liquidity of the types of financial instruments held by the underlying hedge funds.

I. 3 If the fund of hedge funds' manager decides to implement limited redemption arrangements (such as redemption gates, redemption deferrals) for the purpose of dealing with a liquidity issue, it should consider beforehand whether such arrangements are consistent with the fund of hedge funds' aims and objectives, and comply with the following conditions:

(a) the conditions relating to the activation of the limited redemption arrangements should be clearly specified in the fund of hedge funds' prospectus for the investors to be appropriately informed;

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4 *Report on Funds of Hedge Funds–Final Report*, Report of the Technical Committee of IOSCO, June 2008, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD276.pdf.

5 *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.

(b) the limited redemption arrangements should only be activated for the purpose of dealing with exceptional situations as clearly defined in the fund of hedge funds' prospectus and should be applied fairly and equitably; and
(c) such a decision should be taken on a collegial basis[6] (provided the size of the fund of hedge funds' manager allows it) and the fund of hedge funds' depositary and unitholders or shareholders should be appropriately informed.

I. 4 Before and during any investment, a fund of hedge funds' manager should always consider whether conflicts of interest may arise between any underlying hedge fund and any relevant other parties. In particular, a fund of hedge funds' manager should consider the nature of the agreements entered into between any underlying hedge fund and its investors, which provide for preferential or more favourable rights to certain investors, through side-letters or other similar arrangements, for the purpose of ensuring that such agreements do not materially affect the fund of hedge funds' interests notably as regards its liquidity and investment terms.

II. The nature and the conditions of the due diligence process used by funds of hedge funds' managers prior to and during investment

II.1 With regard to the elements to be constantly monitored and analyzed by funds of hedge funds' managers

II.1 (a) The fund of hedge funds' manager should establish and implement an appropriate due diligence procedure for the purpose of investment into hedge funds. Such procedure should be reviewed periodically by the manager so as to assess its continued appropriateness, and may rely on existing professional codes or guidelines published by established industry associations.

II.1 (b) For the purpose of the due diligence to be carried out before and during any investment into a hedge fund, the fund of hedge funds' manager should, taking into consideration the specific legal, accounting and disclosure requirements in the hedge fund's jurisdiction**,** make reasonable enquiries to enable it to properly[7]:

1. consider the adequacy of the legal, regulatory and accounting regimes applicable in the jurisdiction of the underlying hedge fund and of its investment manager;
2. consider whether the underlying hedge fund, its investment manager and administrator have complied with their legal, regulatory and contractual obligations (*e.g.,* with regard to the underlying hedge fund's disclosed investment strategy);
3. consider whether the rights attached to the units or shares issued by the underlying hedge fund exist and are enforceable at all times;

[6] This means that the decision to activate limited redemption arrangements should be made pursuant to a checks and balances process. This would for instance cover the case where the decision is taken by an investment decision committee composed of sufficiently skilled and/or experienced parties.

[7] It is worthy of note that the order of presentation of the following items is irrespective of their importance.

4. consider whether the assets of the underlying hedge fund are held separately from those of the custodian and of the latter's potential agents;
5. consider whether the underlying hedge fund distributes appropriate information on a regular basis;
6. confirm that the units or shares issued by the underlying hedge fund are valued at sufficient intervals to permit the fund of hedge funds' manager to meet its reporting requirements to its unitholders;
7. consider whether there is a legally binding requirement for the underlying hedge fund's financial statements to be prepared according to applicable accounting standards, and audited at least annually by an independent auditor in accordance with applicable auditing standards, and obtain the underlying hedge fund's financial statements as audited;
8. confirm that the underlying hedge fund is not incorporated in any country or territory not complying with international anti-money laundering requirements;
9. consider the adequacy of the expertise, experience and qualifications of the underlying hedge fund's portfolio managers and other service providers;
10. consider whether the underlying hedge fund (including its valuation agent) complies at all times with the IOSCO *Principles for the Valuation of Hedge Fund Portfolios*[8] or with valuation principles of established industry associations**,** and notably, whether the methodology used for calculating the hedge fund's value is appropriate;
11. consider the adequacy of the underlying hedge fund's systems, controls, administration, business continuity, trading and execution arrangements;
12. consider the adequacy of the underlying hedge fund's approach to risk management, including governance and accountability, policies and procedures, and compliance;
13. consider the adequacy of the underlying hedge fund's investment strategy notably as regards the fund of hedge funds' risk spreading approach;
14. consider to what extent the underlying hedge fund's investment manager adheres to professional codes or guidelines of good conduct published by established industry associations;
15. consider the adequacy of the method used for the purpose of calculating the underlying hedge fund's performance history, in particular in consideration of applicable performance measurement standards; and
16. in the event the underlying hedge fund's portfolio managers have personally invested in the fund, consider whether the underlying hedge fund has adequate systems to identify any potential conflicts of interest related to such investments.

II.1 (c) The fund of hedge funds' manager should carry out further appropriate due diligence on the underlying hedge fund whenever it considers it necessary or proper to do so.

8 *Principles for the Valuation of Hedge Fund Portfolios–Final Report*, Report of the Technical Committee of IOSCO, November 2007, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD253.pdf.

II.2 With regard to 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:

II.2 (a) For the purpose of carrying out an appropriate due diligence, the fund of hedge funds' manager should have:

1. a documented and traceable procedure for selecting hedge funds: such procedure should be based on a qualitative and quantitative analysis of the underlying hedge funds' characteristics, allowing the fund of hedge funds' manager to assess the legal and operational risks (including potential conflicts of interest) associated with the underlying hedge funds and with the entities involved in running them (*e.g.*, financial managers, depositary, statutory auditor, registrar) as well as the risks arising from the investment strategies and financial instruments used;

2. the adequate human and technical resources to implement this procedure, allowing the fund of hedge funds' manager to identify the aforementioned risks through a collegial decision-making process[9] (provided the size of the fund of hedge funds' manager allows it); and

3. the resources, procedures and organizational structure allowing the fund of hedge funds' manager to deal with anomalies identified when monitoring the selected hedge funds or implementing any other procedures, take any necessary corrective action and confirm that all procedures are traceable and have been catalogued.

II.2 (b) The fund of hedge funds' manager should determine whether the principles used to select eligible investments pursuant to its due diligence procedure have been satisfied.

II.3 With regard to the conditions for authorizing the outsourcing of due diligence:

Before outsourcing any part of its due diligence to a person or entity, the fund of hedge funds' manager should:

a) determine that any potential conflicts of interest that may arise between that person or entity and the fund of hedge funds' manager or the underlying hedge funds' managers are adequately addressed;
b) consider to what extent the outsourcing of due diligence is consistent with the IOSCO *Principles on Outsourcing of Financial Services for Market Intermediaries.*[10]

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[9] This means that any decision should be made pursuant to a checks and balances process.

[10] *Principles On Outsourcing Of Financial Services For Market Intermediaries*, Report of the Technical Committee of IOSCO, February 2005, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD187.pdf.