

# **CONSULTATION REPORT**

## **CALL FOR VIEWS ON ISSUES THAT COULD BE ADDRESSED BY IOSCO ON FUNDS OF HEDGE FUNDS**



**OICU-IOSCO**

**TECHNICAL COMMITTEE  
OF THE  
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

**APRIL 2007**

**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.**

## **Call for views on issues that could be addressed by IOSCO on funds of hedge funds**

IOSCO is inviting all interested parties to submit their views on the key issues that IOSCO could address with respect to funds of hedge funds that issue shares to retail investors.<sup>1</sup>

The worldwide size of funds of hedge funds has been assessed at USD 500 Bln in 2006 (to be compared to USD 83 Bln in 2000 and USD 290 Bln in 2003)<sup>2</sup>. Funds of hedge funds appear to be the most common vehicle for the industry to promote retail investment into alternative strategy funds. Moreover, since the release of the previous IOSCO Technical Committee Standing Committee on Investment Management (SC5)<sup>3</sup> report on this issue, the regulation of funds of hedge funds has become a priority for a larger number of jurisdictions<sup>4</sup>.

Following the final publication of the IOSCO Technical Committee report entitled "*The Regulatory Environment for Hedge Funds: a Survey and Comparison*" (November 2006), IOSCO has acknowledged that it was necessary to update its previous work on funds of hedge funds and on the regulatory issues raised by these funds.

Consequently, a list of the related key issues has been established in order to identify more precisely the scope of the work that SC5 could carry out in this area.

All interested parties are invited to express their views:

- on the issues that are listed in this document and
- on possible other issues which could be addressed.

Among the list of issues identified, IOSCO is particularly keen to find out ways to address the following items:

- information regarding the selection of the underlying funds and their related risks;
- the due diligence and on-going monitoring process to be performed by the fund of hedge funds' manager and more particularly the constitutive elements of this process;

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<sup>1</sup> With respect to the United States' markets, IOSCO encourages responses to this call for views regarding: (1) funds of hedge funds that are registered as investment companies with the U.S. Securities and Exchange Commission; and (2) commodity pool operators that are registered with the Commodity Futures Trading Commission and operate funds of hedge funds for which they did not claim any exemption from the reporting, disclosure and recordkeeping requirements that are generally applicable to commodity pools.

<sup>2</sup> Data provided by Hedge Fund Research, Inc.

<sup>3</sup> The IOSCO Technical Committee established SC5 to focus on investment management issues, including those raised by collective investment products such as mutual funds (CIS), closed-end funds and open-ended investment trusts, and discretionary asset management services.

<sup>4</sup> See, e.g., IOSCO Technical Committee report entitled *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds* (February 2003) and IOSCO Technical Committee "*Hedge Funds and Other Highly Leveraged Institutions*" (November 1999).

All views on the possible ways to appropriately address these issues are welcome.

Please note that SC5 has focused on retail investors' increased investment in funds of hedge funds. Hence, the following questions put the emphasis on the conditions under which such retail investments have to be made and in particular, on the due diligence to be carried out by the funds of hedge funds' managers.

### **How to Submit Comments**

Comments may be submitted by one of three methods **at the latest on 20 July 2007**. To help us process and review your comments more efficiently, please use only one method.

#### **1. E-mail**

- Send comments to Ms. Pamela Vulpes: [pamela@iosco.org](mailto:pamela@iosco.org)
- The subject line of your message should indicate "Call for views on issues that could be addressed by IOSCO on funds of hedge funds"
- Please do not submit attachments as HTML, GIF, TIFF, PIF, or EXE files.

**OR**

#### **2. Fax**

Send a fax to the attention of Ms. Pamela Vulpes, using the following fax number:  
34 (91) 555 93 68.

**OR**

#### **3. Post**

Send your comment letter to:

Ms. Pamela Vulpes  
IOSCO General Secretariat  
C/ Oquendo 12  
28006 Madrid  
Spain

- Your letter should indicate prominently that it is a public comment on indicate "Call for views on issues that could be addressed by IOSCO on funds of hedge funds"

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

## ***1. General Background:***

### ***1.1. Key conclusions of the TC report published in February 2003 entitled "Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds":***

During its meeting of 17 and 18 February 2003, the IOSCO Technical Committee approved for public release the report entitled "*Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds*" (the "2003 Report"). Work on this project was initiated in May 2002 when the Technical Committee mandated that SC5 look into the regulatory issues arising from retail investment in hedge funds. The 2003 Report identified specific regulatory issues created by hedge funds and further described some approaches for addressing the consequences that these issues might have on retail investors.

The 2003 Report 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 this sector. It appeared that in some jurisdictions hedge funds and similar vehicles, especially funds of hedge funds, were increasingly targeting retail investors.

The 2003 Report also mentioned issues specific to funds of hedge funds, such as:

- 1. The information on underlying funds and how they are selected:* if investors are to have any idea about the risk profile of a fund-of-funds, they will need information about the nature and risks of the underlying funds (as well as the criteria used by the fund-of-funds' manager in selecting the underlying funds).
- 2. Due diligence on the underlying funds:* one of the critical functions performed by the manager of a fund-of-funds is the performance of due diligence on underlying funds.
- 3. Diversification:* the number of underlying funds that the fund-of-funds invests in and the concentration in individual underlying funds is an important component of the risk of the fund-of-funds.
- 4. "Double" Fees:* it is customary for management and performance fees to be payable both at the fund-of-funds' level and from the fund-of-funds to the underlying funds.
- 5. Investment activity at fund-of-funds level:* normally, funds-of-funds invest on a long-only basis in underlying funds without taking positions themselves. If the fund-of-funds plans to "overlay" the investments in underlying funds by making investments itself, this should be clearly disclosed to investors.

In the 2003 Report, the IOSCO Technical Committee presented the following guidelines relating to jurisdictions that permit the marketing and selling of hedge funds to retail investors. Those guidelines, which generally refer to the top tier fund, may be applicable to jurisdictions in which retail investments are made in funds of hedge funds.

- *Disclosure:* Investors in hedge funds often face a complex combination of risks: market risk, operational risk, credit and counterparty risk etc. In order to understand those risks hedge funds have to disclose their strategies in detail. That means that a complete list should be given with the strategies a fund follows and a description per strategy of the risks involved and the handling of those risks by the fund. It is however not necessary for the funds to reveal their current individual investments. However, hedge funds marketed and sold directly to retail investors should be subject to the same disclosure requirements as other CIS.
  
- *Competent management:* the management and internal control process of hedge funds might require additional attention of the regulator. The complexity of the risks, the investment strategies, the management of the administrative organization and the valuation of the assets can demand special skills. The regulator should consider the adequacy of those skills, while accepting that it is impossible to second-guess the commercial judgments being made by the manager and for which the manager is responsible. This is also important for funds of hedge funds. The manager should be able to make a considered choice between the many funds that he could invest money in, and he must at least understand the strategies of the funds and apply adequate due diligence. The manager should also be able to explain to the investors how the funds' selection takes place, what the procedures for monitoring the funds are, what the criteria used for switching the investments among funds are, and how the valuation takes place.

During the SC5 Paris Meeting (June 2006), a presentation was provided by a French alternative asset manager entitled "*Hedge Funds risks and valuation, The managed account solution.*" This presentation gave SC5 members a more precise view of the main risks to be tackled by the manager of a fund of hedge funds:

1. Fraud
2. Lack of transparency
  - On the exposure to various risk factors (leverage, concentration, use of derivatives, credit risk, etc.)
  - On the management methods
  - Misrepresentation
  - Diversification
3. Lack of independent valuation; since in reality, valuation is supplied by the manager of the underlying hedge funds;
4. Liquidity.

The ability of the manager of a fund of hedge funds to make sure that the valuation process of the underlying fund is accurately and appropriately carried out has been considered as a crucial point<sup>5</sup>.

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<sup>5</sup> In the model of "managed account" which exists only in certain SC5 jurisdictions, two managers, independent from each other, are appointed for being each responsible for separate missions in the Managed Account Model in order to address all these issues and more particularly the valuation process issue of the underlying fund: the « top manager » supervises the mandate, the risks and the valuation, and the « down manager » determines the day to day positions of the fund. The model looks also like a delegation of management structure, where the « top manager » delegates to the « down manager » the financial management, but keeps major control functions.

***1.2. Recent work undertaken by regulators: the example of the UK Financial Services Authority (FSA) document entitled "Wider-range Retail Investment Products: consumer protection in a rapidly changing world":***

More recently, the UK FSA has published a document entitled "*Wider-range Retail Investment Products: consumer protection in a rapidly changing world – Feedback on DP05/3*" in which a proposition was made to extend the range of "Non-UCITS retail Schemes" (NURSSs) in order to include funds of unregulated schemes.

The UK FSA is currently looking at the quality criteria with regard to the selection of underlying unregulated schemes, where those schemes are themselves CIS. For example, the Qualified Investor Scheme (QIS) already requires that an underlying scheme of a fund of unregulated schemes:

- be subject to an annual audit ;
- have its net asset value verified by a person independent from the fund's accountant;
- have the necessary process to enable unit holders to redeem units within a reasonable timeframe;
- not invest more than 15% of its net assets in units of CIS;
- operate in compliance with the principle of risk spreading.

The UK FSA is considering whether these or additional criteria are necessary.

***1.3. Recent requests from the industry: the recommendations of the European Expert Group on Hedge Funds:***

In July 2005, the European Commission launched a public debate on the possible ways to enhance the European framework for investment funds. More recently, with the help of the European Commission services, a group of hedge funds practitioners has recently contributed to the debate on the development of the hedge funds' business in Europe. In its report<sup>6</sup>, this Expert Group mentioned that "*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 inter alia, in France, Germany, Ireland, Luxembourg and Spain. Whilst there are concerns regarding the level of product regulation that some of these regimes introduced, the Expert Group welcomes this approach and believes fund 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 single hedge funds is not appropriate*". Moreover, the Expert Group asked that nationally regulated hedge funds products to be mutually recognized as suitable for sale to the investing retail public across Europe.

As a result, funds of hedge funds seem to be the preferred vehicle by the industry to promote the creation of hedge funds on a cross-border basis in Europe. It was concluded during the June 2006 SC5 meeting in Paris that the regulation of funds of hedge funds had become a priority for the regulatory authorities.

Following the publication of the IOSCO Technical Committee report entitled "*The Regulatory Environment for Hedge Funds : a Survey and Comparison*" (March 2006), the SC5 members

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6. Report of the alternative investment expert group to the European commission, "Managing, Servicing and Marketing Hedge Funds in Europe", page 21 (July 2006).

have indeed decided to initiate an internal survey on funds of hedge funds and on the regulatory issues raised by these types of investment funds.

As a first step, the SC5 members were kindly invited to raise the key regulatory issues they identified in the area of funds of hedge funds. The discussion presented below constitutes a first and preliminary draft of the list of key issues.

## **2. Preliminary identification of the key regulatory issues related to funds of hedge funds:**

**2.1.a Information for fund of hedge funds managers and investors:** Information regarding the investment strategies and the related risks of the underlying funds is of crucial importance both for the manager of the fund of hedge funds and the investors.

**2.1.b Manager's risk management systems:** In order to evaluate and monitor the strategies of the underlying funds, and their related risks, and to ensure that the fund of hedge funds follows its contractual terms concerning its investment strategy, a fund of hedge funds needs a robust risk management system in place. A risk management system will facilitate risk identification and evaluation, control of perceived risks, and the communication of the risks to investors as appropriate.

Initially risk management has to be carried out by the fund of hedge funds' manager. However, a risk controlling unit independent of the manager could complement the risk management of the fund of hedge funds.

Meanwhile, it is recognized that providing too many details on the risk management organization of the fund of hedge funds to retail investors may not be relevant and useful for retail investors. Adequate information about the nature and risks of the underlying funds needs to be provided to investors in an easily understood format. The offering documents of the fund of hedge funds should be required to describe the investment style and strategies that the manager intends to pursue in a comprehensive way as well as the risks attached to the instruments and techniques employed within these strategies.

### **QUESTIONS:**

1. Regarding the risk monitoring by the manager of a fund of hedge funds, what disclosure standards could regulators promote in relation to the information about that monitoring? In particular, what information could be provided to retail investors? Please, explain your comments.
2. Regarding the investment strategies that are carried out by a fund of hedge funds (including the underlying funds' strategies), what disclosure standards could regulators promote in relation to the information about those strategies? In particular, what information could be provided to retail investors? Please, explain your comments.

## **2.2 Nature and frequency of the delivery of information by the fund of hedge funds to investors:**

SC5 members understand that some managers of funds of hedge funds are quite reluctant to display the breakdown and details of the underlying funds that they hold in their portfolios, on the ground that they run the risk of disclosing proprietary and confidential information to their competitive disadvantage. This should be considered when deciding the costs and benefits of disclosing the positions of the fund of hedge funds on an on-going basis.

It is interesting to note that as an alternative, one SC5 jurisdiction allows the use of a specific disclosure format where the precise name of the underlying funds and the name of their managers are not disclosed. However, under this format, the underlying funds have to be listed individually and identified by an alphabetical or numerical code, which is used consistently throughout the life of the holdings, thereby allowing investors to make comparisons between accounting periods. This SC5 regulator has nevertheless reserved the right that it may request a comprehensive listing of all underlying funds and their managers.

### **QUESTION:**

3. Once an investor has purchased the units/shares of a fund of hedge funds, what information should be delivered to him on an ongoing basis and how frequently?  
Please, explain your comments

## **2.3 Regulatory approaches to funds of hedge funds managers for selection of the underlying hedge funds: method used for selecting the underlying funds:**

Some SC5 members' regulatory authorities impose eligibility criteria for the selection of the underlying funds. For instance, they prescribe that:

- the underlying funds' home country have a legislation compliant with the international provisions relating to the prevention of the money laundering and the financing of terrorism;
- the regulation in the underlying funds' home country stipulate that the funds' annual financial statements be certified by a statutory /external auditor;
- the entity that manages or provides investment advice to the underlying funds be subject to the supervision of an authority that regulates such activities and with which the said entity is registered;
- some guarantees be given with regard to the custody of the underlying funds' assets and the responsibility of the underlying funds' custodian. For instance, some regulators impose a condition according to which investment can only be made in those underlying funds with independent trustees/custodians;
- the underlying funds be valued independently;
- the underlying funds be managed by entities which possess the relevant experience and expertise;
- controls be carried out on investments in new start-up funds (e.g., minimum track record for underlying funds);
- there be adequate risk monitoring and internal control systems at the underlying funds' level and at the fund of funds' level (for aggregation purposes);

- there be on-going monitoring of underlying funds conducted in a consistent manner with proper controls and process in relation to risk, leverage and concentration levels.

Other SC5 regulatory authorities have a more principles-based approach which imposes general due diligence requirements on the manager with respect to selecting underlying funds. Pursuant to this principles-based approach, the responsibility attached to the underlying funds' selection and the adequate monitoring of the related risks lies on the fund of hedge funds' manager. In some jurisdictions, the regulator may also examine the expertise, skills and competence of the fund of hedge fund manager in connection with the authorization of the manager of the fund of hedge funds.

## **QUESTIONS**

4. With regard to the first approach, what criteria for the eligibility of underlying funds would be appropriate or necessary?
5. With regard to the second approach and jurisdictions that authorize fund managers, what should the regulator consider with respect to the manager's due diligence process (*e.g.*, types of controls, etc.) and in which cases could the fund of hedge funds' manager be deemed responsible? Please, explain your comments.

### ***2.4 Performance target/prospective financial information:***

In some jurisdictions, funds of hedge funds disclose target performance (*e.g.*, a fund may seek to outperform a specific index). Because some hedge funds (and fund of hedge funds) pursue absolute return strategies, it seems unrealistic, as a preliminary view, to encourage those managers to disclose their target performance.

## **QUESTION:**

6. How should regulators approach the use of target performance by funds of hedge funds? If funds of hedge funds disclose different performance targets, will investors be able to assess the performance targets? Does the comparison of a fund's performance with a benchmark assist investors in assessing performance targets? Please, explain your comments.

### ***2.5 Fees and expenses:***

The investment of funds of hedge funds in underlying funds raises two main questions in respect of fees and expenses which have been already covered by a previous IOSCO report<sup>7</sup> in the more general case of CIS.

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<sup>7</sup> See IOSCO Technical Committee report (November 2004) entitled "*Final Report On Elements Of International Regulatory Standards On Fees And Expenses Of Investment Funds, Report of the Technical Committee of IOSCO*".

The first question relates to the fact that funds of funds often or usually involve a double fee structure. This double fee structure is not in itself illegitimate as two different types of services are remunerated: fees relating to the top-tier fund level remunerate the fund's manager for the asset allocation and the selection of the underlying funds, and fees relating to the bottom-tier fund level remunerate the funds' managers for the management of these underlying funds. The situation can be made more complex by the possibility for funds of hedge funds to invest in other funds of hedge funds, leading to a multiplicity of fee layers.

The second issue relates to the conflict of interests that may arise when the underlying funds are managed by the same manager as the fund of funds' or by an affiliated party, or where fee-sharing agreements between the top-tier and bottom-tier funds unduly benefit to the top-tier operator or where these agreements may bias the selection process of the underlying funds by the manager of the fund of hedge funds. IOSCO best practice standards<sup>8</sup> state that if permitted, fee-sharing agreements should benefit exclusively the top tier fund. They should not benefit the management company, be it directly or through a third party. Furthermore, if the top tier fund invests in funds managed by affiliated parties, this should be disclosed to investors and subscription/redemption fees should be waived (except for those fees that go to the fund to cover the costs linked to the subscription/redemption).

It may be worth considering whether these principles adequately cover the specific situation of the funds of hedge funds due to the total amount of fees charged by hedge funds and the potentially high number of fee layers, especially when a fund of hedge funds invests in other funds of hedge funds.

## **QUESTIONS:**

7. Given the potential multiplicity of fee layers in the case of funds of hedge funds, how should the regulatory framework handle the fee and expenses issue? Are the general IOSCO principles sufficient to address this issue in the case of funds of hedge funds investing in other funds of hedge funds?

8. What regulatory responses would be necessary to deal with the potential conflicts of interests arising from fee sharing agreements between the bottom-tier fund and the top-tier fund?

### **2.6 *Diversification/Investment Restrictions:***

In some jurisdictions, there is a question relating to the appropriate number of underlying funds that the fund-of-funds may invest in, and a question about the concentration of the investments into one or a few underlying funds.

In addition, a fund of hedge fund's investment in underlying funds that pursue identical investment strategies may raise some concerns. One might contemplate setting up limits or conditions as regards the strategy correlation between the underlying funds in terms of risk diversification. As an alternative, one might also consider giving some flexibility to the fund of hedge funds' manager to ensure diversification.

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<sup>8</sup> See IOSCO Technical Committee report (November 2004) entitled "*Final Report On Elements Of International Regulatory Standards On Fees And Expenses Of Investment Funds, Report of the Technical Committee of IOSCO*".

## **QUESTIONS:**

9. Should there be limits or conditions on the extent of “overlay” that a fund of hedge funds could do to avoid a fund of funds from making excessive direct investments (and acting like a single hedge fund). If so, what limits or conditions should there be?

10. Should regulators recommend or require minimum levels of diversification and concentration (e.g., limits of number of underlying funds and maximum percentage of fund value invested in each underlying fund or funds with the same strategies), and, if so, what minimum levels? Please, explain your comments.

### ***2.7 Lock up Periods/Liquidity:***

Lock up periods for the underlying funds (times during which investors are not entitled to redeem their units) and restrictions on the redemption frequency (and notice periods for redemptions) at the level of the underlying hedge funds raise concerns for investors in the funds of hedge funds. Those restrictions on the underlying funds limit the liquidity of the investments in the funds of hedge funds for their unitholders.

## **QUESTION:**

11. Should fund of hedge funds managers be encouraged or required to have facilities (e.g., credit facilities) for the purpose of meeting any redemption requests, and, if so, how should fund of hedge fund managers be encouraged to have such facilities? In what circumstances could the fund of hedge funds be allowed to suspend and/or postpone redemptions? Do funds of hedge funds present other liquidity issues for retail investors? Please, explain your comments.

### ***2.8 Valuation:***

SC5 recently examined issues relating to the valuation of hedge fund portfolios<sup>9</sup>. Similar issues may arise in connection with the valuation of funds of hedge fund portfolios.

In the context of funds of hedge funds, the frequency of calculation of the net asset value (“NAV”) of each underlying hedge fund is often different and also may vary from when the fund of hedge funds does so. Some underlying hedge funds may only periodically calculate NAV, such as quarterly or monthly. During the periods between calculations of NAV, some underlying hedge funds may report an estimated NAV. If the fund of hedge funds’ manager receives estimated NAVs from the underlying hedge funds, for use in calculating the fund of hedge funds’ own NAV, there may be risks of errors in so far as the estimated NAVs are not reliable. Meanwhile, if the fund of hedge fund issues redeemable securities, it must be ensured that each investor subscribes and redeems his unit/share based on a reliable NAV.

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<sup>9</sup> See IOSCO Technical Committee report “*Principles for the Valuation of Hedge Fund Portfolios*” (March 2007)

## **QUESTIONS:**

12. What are the common ways in which funds of hedge funds purchase, sell or redeem their interests (*e.g.*, listed on an exchange, periodic repurchase offers, and redemption)? Please, explain how valuation issues affect funds of hedge funds and investors based on how the funds' share interests are offered and sold.

13. Would it be appropriate to require or recommend frequency of valuation for the underlying hedge funds (monthly, for instance), and, if so, what minimum frequency would it be appropriate to require or recommend? Please, explain your comments.

14. How should the manager of a fund of hedge funds address discrepancies in the timing of valuations between underlying funds and the fund of hedge funds? Please, explain your comments.

15. What level of due diligence concerning the underlying funds' NAV calculations can the fund of hedge funds be expected to perform? What specific due diligence concerning the underlying funds' NAV calculations should the fund of hedge funds manager carry out?

### **2.9 *Leverage:***

A fund of hedge funds may, pursuant to its investment strategy, employ leverage even if its interests may be distributed to retail investors. The underlying hedge funds also may employ leverage. This may lead to multiple accesses to leverage and a specific need for adequate information on the maximum level of leverage achieved by the fund.

## **QUESTION:**

16. Does the use of leverage present unique issues for funds of hedge funds? Should regulators promote particular standards to address leverage in the specific context of funds of hedge funds (*e.g.*, borrowings and/or exposure through the use of derivatives and other financial instruments, exposure through underlying hedge funds), and, if so, which standards? What kind of disclosure standards would be necessary to ensure an appropriate level of information on the total amount of leverage accessible to a fund of hedge funds? Please, explain your comments.

### **2.10 *Marketing:***

In many SC5 jurisdictions, fund of hedge funds interests are offered and sold to retail investors with some regulatory safeguards in place. Some SC5 member jurisdictions may contemplate establishing minimum subscription thresholds to filter out investors for whom such investments are not viewed as suitable. Some jurisdictions may consider imposing specific risk disclosure requirements at the "point of sale".

## **QUESTION:**

17. What standards and rules should regulators consider to address the suitability of the sale of funds of hedge fund interests to retail investors? Please, explain your comments.

### **3. Preliminary identification of the key issues regarding the manager of the fund of hedge funds and the nature of its due diligence:**

#### ***3.1 Management skills and due diligence with regard to the underlying hedge funds:***

The management and internal control processes of funds of hedge funds do require special skills given the complexity of the risks involved, the investment strategies, the management of the administrative organization and the valuation of the funds' assets. In practice, the manager of a fund of hedge funds frequently carries out a due diligence process regarding underlying funds on an ongoing basis. This due diligence process may cover:

- monitoring the investment strategies used by the underlying hedge funds;
- assessments of the quality of the organization of the underlying hedge funds and their managers (including experience and expertise of the key personnel) and monitoring of this quality on an ongoing basis ;
- the ability to manage *legal issues* associated with the underlying funds, such as the consequences of the bankruptcy/fraud of an underlying fund.

How the manager monitors the risk/performance profile of the underlying funds on an ongoing basis is an important element of the operations for funds of hedge funds. The due diligence process should ensure that the monitoring occurs on an ongoing basis. Consideration should be given to key information the manager should obtain, from the underlying funds and their related parties, to perform the due diligence process in a satisfactory and successful manner (*e.g.*, frequency of the reporting and evaluation, analysis/controls of the investment risks and operational risks of the underlying funds etc).

#### **QUESTION:**

18. What best practices could be formulated at the international level regarding the due diligence process to be performed by the manager of the fund of hedge funds? Please, explain your comments.

#### ***3.2 Transparency for manager monitoring:***

SC5 members have noted that some funds of hedge funds obtain near total transparency in terms of investment positions, risks levels, leverage and other information from their underlying funds, on an ongoing basis. Other funds of hedge funds may not reach such a high level of transparency.

#### **QUESTION:**

19. What level of transparency concerning the underlying funds is required for managers to conduct their due diligence? What level of transparency concerning the underlying funds should be required for managers to conduct adequate due diligence? Is a similar or different level required for investors? Along with the role of transparency in the top tier manager's due diligence, what other issues does transparency raise, *e.g.* for the underlying funds?

### 3.3 *Side letters:*

Side letters generally are agreements between a hedge fund and one of its investors whereby the investor has unique rights with respect to the fund (such as the ability to redeem its shares at a particular time). The use of side letters raises issues concerning the equitable treatment of all of the unit/shareholders of a fund of hedge funds.

#### **QUESTION:**

20. Are side letters common among funds of hedge funds? Do side letters raise concerns for managers and investors in funds of hedge funds, and if so, how should those concerns be addressed?

### 3.4 *The delegation (outsourcing) of some of the functions by the fund of hedge funds' management company, including the calculation of the NAV or even the selection of the underlying funds:*

Delegation of some functions, including due diligence tasks, is said to be a common practice in the fund of hedge funds' industry. In this sense, the delegation practices and requirements, both for the entity to which the functions are delegated and for the fund of hedge funds' manager, should be carefully monitored from a regulatory point of view. For example, a manager of a fund of hedge funds should have enough resources and sound procedures to control the activities under delegation and maintain enough resources in order to avoid becoming a "letterbox".

#### **QUESTION:**

21. How common is delegation and what sorts of functions are typically delegated in connection with funds of hedge funds? Should regulators address delegation (including the scope of delegations, identity and competence of the delegation), and, if so, how? Should certain delegations be prohibited?

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