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International Organization of Securities Commissions
Organisation internationale des commissions de valeurs
Organização Internacional das Comissões de Valores
Organización Internacional de Comisiones de Valores

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IOSCO publishes due diligence good practices for investment managers

The International Organization of Securities Commissions' (IOSCO) Technical Committee has published a final report - *IOSCO Good Practices in relation to Investment Managers' Due Diligence When Investing in Structured Finance Instruments* (Investment Manager Due Diligence Practices) – which contains guidelines aimed at assisting both investment management industry participants and regulatory bodies, in assessing the quality of their due diligence procedures regarding investments in structured finance instruments (SFI) by collective investment schemes (CIS) offered to retail investors.

The Investment Manager Due Diligence Practices were developed in cooperation with industry representatives following the recommendation made in the *Report of the Task Force on the Subprime Crisis*, published in May 2008, that the Technical Committee's Standing Committee on Investment Management (TCSC5) conduct work, and develop good practices, on investment managers' due diligence processes and procedures when investing in structured finance instruments on behalf of collective investment schemes (CIS) offered to retail investors.

Key Messages

The Investment Manager Due Diligence Practices are based on five key messages that should inform any review, development or reconsideration of due diligence policies and procedures. These are:

- Investing in a structured finance instrument (SFI) is different from investing in a more traditional instrument often referred to as a *plain vanilla* instrument. The risks are different, and call for a tailored due diligence process;

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- If you do not understand a SFI, do not buy it;
- Due diligence is and must remain a value-added process. It is not and must never become a plain box-ticking process;
- Due diligence is generally a three step, and iterative process, which is structured around the understanding of the underlying assets of the SFI, of its structure and of how it fits into the CIS mandate; and
- Due diligence is not a static process. It is an on-going process, which starts at the time the initial investment in the SFI is contemplated and ends when the SFI matures or is divested.

IOSCO Investment Manager Due Diligence Good Practices

These good practices are aimed at assisting industry and regulators in their understanding, assessment and monitoring of investments in SFIs on behalf of CIS'. The practices are broken down into the three stages which should be included in the due diligence process, and also address the question of the use of third parties in the due diligence process, including credit rating agencies. The three stages are:

1. Analysing the underlying assets of the SFI

When assessing a SFI, investment managers should assess the availability, reliability and relevance of information available both on the market and on the underlying assets;

i. The unique properties of the specific pool of assets shouldn't be assumed to be identical to the broader asset category. Investment managers should ensure that their analysis of the underlying assets is based on information that is relevant for that specific type of underlying assets;

2. Analysing the structure of the SFI

iii. The analysis of the structure of the SFI should be conducted both in “normal” and in “stress” scenarios;

iv. The investment manager should also ensure that he has or has access to the right expertise to conduct an analysis of a particular SFI, including legal expertise;

v. Whatever the structure of the SFI, the asset manager should understand how cash flows will be allocated to the different tranches of the SFI;

vi. The asset manager should use the practices laid out in this paper to build his own opinion on the SFI: is the price right for the risks taken on behalf of the investors;

3. How does the SFI fit into the CIS mandate

vii. The investment manager should check that investing in the SFI on behalf of the CIS is consistent with the disclosures, mandate and internal operations of the CIS.

Use of Third Parties in the Due Diligence Process

The investment manager should understand the methodology, parameters and basis on which the opinion of a third party was produced. He should have adequate means and expertise to challenge the methodology and parameters.

The Technical Committee is not adopting principles with respect to due diligence in this paper, however it may choose to undertake such a project in the future.

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NOTES FOR EDITORS

1. The *IOSCO Good Practices in relation to Investment Managers' Due Diligence When Investing in Structured Finance Instruments – Final Report, Report of the Technical Committee of IOSCO* is available on the IOSCO website.

2. The *Report on the Subprime Crisis – Final Report, Report of the Technical Committee of IOSCO* is available on the IOSCO website.

2. IOSCO is recognized as the leading international policy forum for securities regulators. The organization's membership regulates more than 95% of the world's securities markets in over 100 jurisdictions and its membership is steadily growing.

3. The Technical Committee, a specialised working group established by IOSCO's Executive Committee, is made up of 18 agencies that regulate some of the world's larger, more developed and internationalized markets. Its objective is to review major regulatory issues related to international securities and futures transactions and to coordinate practical responses to these concerns. Ms. Kathleen Casey, Commissioner of the United States Securities and Exchange Commission is the Chairman of the Technical Committee. The members of the Technical Committee are the securities regulatory authorities of Australia, France, Germany, Hong Kong, Italy, Japan, Mexico, the Netherlands, Ontario, Quebec, Spain, Switzerland, United Kingdom and the United States.

4. IOSCO aims through its permanent structures:

   - to cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets;
   - to exchange information on their respective experiences in order to promote the development of domestic markets;
   - to unite their efforts to establish standards and an effective surveillance of international securities transactions;
   - to provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.

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