CFA INSTITUTE | Centre for Financial Market Integrity

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

5th January 2009

Dear Ms Allen,

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

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre") welcomes the opportunity to comment on the International Organization of Securities Commissions ("IOSCO") consultation on "Proposed Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices" (the "Consultation").

The CFA Institute Centre[1] promotes fair, open, and transparent global capital markets, and advocates for investors' protection. We are supportive of IOSCO's efforts to set forth clear principles based on best market practice for funds of hedge funds. These schemes are the primary vehicle through which retail investors gain exposure to hedge funds. Accordingly, investor protection considerations are of key importance.

The Consultation addresses (I.) the methods by which fund of hedge funds' managers deal with liquidity risk; and (II.) the due diligence process used by fund of hedge funds' managers prior to and during investment. The focus of the Consultation stems from IOSCO's June 2008 *Report on Hedge Funds*, which identified additional investor protection regulatory issues concerning liquidity risk and due diligence.

The CFA Institute Centre is fully supportive of IOSCO's proposals. With regards to liquidity risk, these proposals focus on ensuring consistency between the liquidity of the fund of hedge funds (the "Fund") and the underlying hedge funds, managing conflicts of interest, and establishing firm criteria for the implementation of limited redemption arrangements. The proposals relating to the due diligence process comprise 16 elements that address legal and regulatory requirements, valuation principles, risk management, performance measurement, and ethical practice. The due diligence proposals also address organisational resources and outsourcing arrangements.

[1] The CFA Institute Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

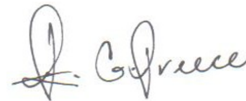
Charlottesville New York Hong Kong London
10th Floor, One Canada Square
Canary Wharf, London E14 5AB
United Kingdom
+44 (0)20 7531 0750 tel
+44 (0)20 7531 0767 fax
infoeu@cfainstitute.org
www.cfainstitute.org

These measures are of primary importance to protect retail investors from the risks inherent in hedge funds. Typically, retail investors lack the expertise to understand hedge fund strategies and risks, and often do not possess adequate resources to withstand volatile performance or financial losses. This emphasizes the importance of both the due diligence process and liquidity risk management, which serve to ensure that investors' interests are protected in hedge fund selection decisions and in the ability to meet redemption requests or fulfil repurchase obligations.

A key feature of robust due diligence and liquidity management (specifically as regards the liquidity of the underlying portfolio holdings) is transparency. Full and regular disclosures of the risks inherent in the portfolio hedge funds not only enable Fund managers to make a better assessment of the suitability of a given hedge fund, but also enable investors to evaluate the objectivity of their Managers' actions.

We attach our response that addresses the proposals of the Consultation. Please do not hesitate to contact us should you wish to discuss any of the points raised.

Yours faithfully,



Charles Cronin, CFA
Head, CFA Institute Centre,
Europe, Middle East and Africa

+44 (0)20 7531 0762
charles.cronin@cfainstitute.org

Rhodri G. Preece, CFA
Policy Analyst, CFA Institute Centre,
Europe, Middle East and Africa

+44 (0)20 7531 0764
rhodri.preece@cfainstitute.org

The CFA Institute Centre is part of CFA Institute[2]. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 87,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

Our detailed comments follow the order of the Consultation's proposals.

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

A key consideration for retail investors is the ability of the fund of hedge funds manager (the "Manager") to meet redemption requests, or, for closed-ended structures, to fulfil repurchase obligations. To this end, the Manager should manage the liquidity of the Fund to an extent that is commensurate with the level of liquidity in the underlying hedge funds. The ability to meet withdrawal obligations is dependent upon the ability to liquidate portfolio holdings; hence the Manager should give due consideration to the liquidity of the assets held by the portfolio funds on a continuous basis. In this regard, liquidity considerations overlap with the due diligence process.

In circumstances where the liquidity of the underlying funds deteriorates such that Fund withdrawal obligations may be compromised, the Manager may consider implementing limited redemption arrangements[3], as noted in paragraph I.3 of the Consultation. In the interests of investor protection, we believe that such facilities should only be implemented in exceptional circumstances, for a limited period, and provided that investors are made aware of this facility prior to subscription via clear and prominent disclosures in the prospectus. Accordingly, we are fully supportive of section I.3 paragraphs (a) and (b), which reflect these considerations. Furthermore, Paragraph (c) requires that the decision to implement limited redemption arrangements be taken on a "collegial basis[4]", and that the depositary and unit/share holders are appropriately informed. We consider that the depositary's determination that the limited redemption arrangement is acceptable under the terms of the prospectus be an important part of the checks and balances process, and therefore recommend that para. (c) be amended to this effect.

We are also supportive of paragraph I.4 which addresses conflicts of interest. In particular, the proposals suggest that appropriate consideration be given to the nature of any agreements entered into between portfolio hedge funds and their investors (or specific classes of investors). The CFA Institute Centre agrees that such agreements could,

---

[2] CFA Institute is best known for developing and administrating the Chartered Financial Analyst curriculum and examinations and issuing the CFA Charter.

[3] Examples cited in the Consultation include redemption gates, redemption deferrals, and (separately) side letters. Whilst recognizing the non-exhaustive nature of this list, we also wish to draw attention to side pockets, or redemption sub-funds. In order to minimize conflicts of interest under such arrangements, the Manager should provide full disclosure of the nature of the redemption sub-fund to investors, so that they can determine whether the fee structure for this portion of the Fund's assets is acceptable.

[4] The Consultation defines "collegial basis" as a decision that is subject to a checks and balances process, such as an investment decision committee composed of sufficiently skilled individuals. We recommend that the investment decision committee include representatives of Fund investors.

in some circumstances, present a conflict of interests with regards to the liquidity considerations of the Fund. As the Consultation notes, it should be incumbent upon the Manager to ensure that such agreements *"do not materially affect the Fund's interests notably as regards its liquidity and investment terms"*.

To this end, it would be in investors' best interests if the Manager disclosed, where possible, the nature of these arrangements and the conclusions drawn thereon regarding their potential impact on the Fund. Disclosure of conflicts of interests protects investors by providing them with the information they need to evaluate the objectivity of their Managers' actions, and by giving them the information to make their own determination regarding the circumstances, motives, or possible bias of the Manager's decisions.

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 analysed by funds of hedge funds' managers

A comprehensive and robust due diligence process, on the part of both the Manager and the investor, is of particular importance to retail investors seeking to gain exposure to hedge funds. Specifically, such investors may lack the depth of knowledge and expertise of their institutional counterparts. Accordingly, the due diligence process forms a central component of retail investor protection.

The CFA Institute Centre is therefore fully supportive of the recommendations of section II.1 of the Consultation. Paragraph II.1(a) states:

> *"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…, and may rely on existing codes or guidelines published by established industry associations"*

To further these goals, the CFA Institute Centre has published its own code of conduct, entitled, "*Asset Manager Code of Professional Conduct*[5]" (the "Code"). The goal of the Code is to set forth a framework for asset managers (including hedge fund managers) to provide services in a fair and professional manner and to fully disclose key elements of these services to clients.

The importance of the due diligence process is exemplified by section B of the Code, "Investment Processes and Actions". This states that Managers must "Have a reasonable and adequate basis for investment decisions". The guidance to this principle states that:

> *"Managers must analyze the investment opportunities in question and should act only after undertaking due diligence to ensure there is sufficient knowledge about specific investments or strategies."*

---

[5] See *CFA Institute Centre for Financial Market Integrity, "Asset Manager Code of Professional Conduct"*, at http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n4.4008. A revised version of the Code is due to be published in forthcoming months.

The elements of the due diligence process proposed in the Consultation are set out in paragraph II.1(b) points 1-16. Broadly, these comprise legal, regulatory, and accounting requirements, valuation principles, risk management requirements, performance measurement, and ethical practice based on codes of conduct and minimising conflicts of interest. We make the following specific observations (references to the Consultation in italics):

5. Consider whether the underlying hedge fund distributes appropriate information on a regular basis.

Transparency of the underlying hedge fund is essential for the Manager to be able to make a proper assessment of the suitability of a given fund. Specifically, the appropriate information that the Manager would need with regards to the underlying hedge fund includes (but is not limited to):

- the strategies used by the hedge fund (and the associated risks);
- fund performance information (both absolute and relative);
- the background and experience of the hedge fund manager;
- a list of portfolio holdings at regular intervals;
- the valuation methods and relevant assumptions applied to those portfolio holdings;
- audited financial statements, in addition to details on the auditor itself.

By extension, this information should be made available at regular periods for the fund of hedge funds itself.

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.

10. Consider whether the underlying hedge fund complies at all times with the IOSCO Principles for the Valuation of Hedge Fund Portfolios or with valuation principles of established industry associations, and notably, whether the methodology used for calculating the hedge fund's value is appropriate.

The valuation of the units of the fund of hedge funds should be timely with regards to the valuation of the units of the portfolio hedge funds. Specifically, the Manager should ensure that the periodicity of the valuations carried out by the underlying hedge fund managers is sufficiently frequent for the valuation of the Fund's units to be timely and accurate. This enables unitholders to more accurately assess the fair value of their holdings.

Valuations are a key component to enable investors to properly assess the risks associated with a hedge fund. Accordingly, the Manager needs timely, relevant and standardised valuations, as well as information about the assumptions which could significantly affect the reported value.

12. Consider the adequacy of the underlying hedge fund's approach to risk management, including governance and accountability, policies and procedures, and compliance.

A transparent, robust framework for managing risks is of key importance to protect investors' interests and maintain confidence in the hedge fund industry. Recent financial market turbulence has only highlighted the importance of the risk management function. We are therefore supportive of the focus afforded to risk management in IOSCO's proposed elements of the due diligence process.

The forthcoming Addendum to the CFA Institute Centre's *Asset Manager Code of Professional Conduct* addresses risk management. Under Section D "Compliance and Support", it is proposed that Managers must:

> *"Establish a risk management process that identifies, monitors, and analyzes the risk position of the Manager and its investments, including the sources, nature, and degree of risk exposure."*

For example, Managers following best practice should consider performing stress tests, scenario tests, and back-tests as part of developing risk models that comprehensively capture a full range of actual and contingent exposures.

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.

Best market practice is based on adherence to professional codes of conduct founded on ethics and transparency. Whether it is the CFA Institute Centre's *Asset Manager Code* or another established industry code, the Manager should consider whether the manager of the underlying hedge fund has demonstrated full compliance with such a code. We believe this to be a key consideration of the due diligence process, that strengthens the integrity of the hedge fund selection decisions.

Additionally, in evaluating the methodology used to calculate fund performance, we recommend that the Manager consider whether the underlying hedge fund adheres to the *Global Investment Performance Standards*[6] *(GIPS®)*. GIPS® is a set of standardised, industry-wide ethical principles that provide investment firms with guidance on how to calculate and report their investment results to prospective clients.

<u>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</u>

The provisions of section II.2 focus on having a documented and traceable procedure for hedge fund selection, adequate resources and procedures to implement the due diligence process, and checks to ensure that the principles used to conduct due diligence have been satisfied.

[6] CFA Institute created and administers the GIPS standards and partners with local country sponsors around the world to promote the GIPS standards. For more information, visit http://www.gipsstandards.org/ .

As noted in our Code (Section D "Compliance and Support"), detailed, firm-wide compliance policies and procedures are critical tools to ensure that Managers meet their legal requirements when managing client assets. Documented compliance procedures can assist Managers in fulfilling their responsibilities with regards to the due diligence process.

More specifically, Section D.5 states that Manages must *"Employ qualified staff and sufficient human and technological resources to thoroughly investigate, analyze, implement, and monitor investment decisions and actions."* The guidance to this principle states that:

> *"Managers must employ adequate resources to carry out the research and analysis needed to implement their investment strategies with due diligence and care."*

Furthermore, the guidance in section II.2 could be strengthened by recommending the appointment of a dedicated compliance officer in appropriate situations. The compliance officer would be responsible for administering the policies and procedures and for investigating issues regarding professional conduct.

<u>II.3 With regard to the conditions for authorizing the outsourcing of due diligence</u>

Outsourcing of business functions (such as due diligence) is often a cost-effective method of managing the Fund's operations. The Consultation's proposals on outsourcing of due diligence address (a) managing conflicts of interest, and (b) the extent to which outsourcing is consistent with the *IOSCO Principles on Outsourcing of Financial Services for Market Intermediaries.* We recommend that the due consideration also be given to the following points.

Firstly, in order to ensure that investor protection is not compromised as a result of an outsourcing arrangement, it is essential that the Manager (or those charged with governance of the Fund) retains full responsibility for the outsourced function. To this end, it is necessary to establish clear written mandates that define the role and responsibilities of the outsourced provider.

Secondly, It is necessary for adequate supervision and oversight of the outsourced function, to determine whether the vendor's personnel, procedures, and technical resources are sufficient to conduct thorough due diligence. Periodic reviews should be conducted by the Manager to ensure that the vendor's performance is in line with its mandate.

Thirdly, we recommend that, prior to entering into contractual obligations and on a periodic basis during the contractual period, the outsourced provider should conduct due diligence on the Fund to ensure that it has the resources necessary to maintain continuity of the business relationship. Frequently changing the outsourced provider is not in investors' best interests due to the operational risks arising from the transfer of data and records. Therefore, it is important for the provider to establish the financial commitment of the Fund into the outsourced relationship prior to agreeing contractual terms.

5th January 2009.