

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

Final Report



OICU-IOSCO

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

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Foreword

In the report on *Funds of Hedge Funds – Final Report* dated June 2008¹ and for the purpose of completing the principles provided for the report entitled *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds* as published in February 2003², the International Organization of Securities Commissions' (IOSCO) Technical Committee Standing Committee on Investment Management (TCSC5) proposed developing 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 developed³:

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 unit holders or shareholders pursuant to the fund of hedge funds' prospectus.

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 (including, but not limited to, redemption gates or redemption deferrals) for the purpose of dealing with a potential 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;

¹ *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>.

² *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>.

³ These standards are not intended to serve as comprehensive requirements as far as funds of hedge funds are concerned. Generally, these standards reflect a level of common approach and a practical guide currently acknowledged by regulators. Moreover, implementation of the standards may vary from jurisdiction to jurisdiction, depending on local conditions and circumstances

(b) the limited redemption arrangements should only be activated for a limited period of time and for the purpose of dealing with exceptional situations in the interest of the unit holders or shareholders as clearly stated 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 basis⁴ (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 any investors, which provide for preferential or more favourable rights to certain investors, through side-letters or other similar arrangements, and should appropriately disclose the existence of any such side-letters or other similar arrangements which 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 fund of hedge funds' manager so as to assess its continued appropriateness, and should take into account 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 properly⁵:

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, custodian 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;

⁴ 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.

⁵ The following items are listed in no particular order

- 4.** consider whether the assets of the underlying hedge fund are held separately, within the meaning of the law applicable in the jurisdiction in which the fund of hedge funds is domiciled, from those of the underlying hedge fund's custodian and of the custodian's potential agents, whether the underlying hedge fund's custodian is affiliated with the underlying hedge fund's manager and whether the assets of the underlying hedge fund are appropriately verified;
- 5.** consider whether the underlying hedge fund provides sufficient transparency, such as distributing appropriate information on a regular and timely 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 unit holders;
- 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; whether it can obtain the underlying hedge fund's financial statements as audited; and the reputation of the auditor used by the underlying hedge fund;
- 8.** confirm that the underlying hedge fund is incorporated in a country or territory that complies 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, and consider whether the underlying hedge fund's portfolio managers and other service providers have been held liable for breaches of applicable law and/or professional rules or standards, and have as a result been subjected to sanctions (including but not limited to disciplinary sanctions);
- 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*⁶ 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 (such consideration may include but is not limited to the type and level of leverage used by the underlying hedge fund);
- 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;

⁶ *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>.

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;

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; and

17. consider whether the underlying hedge fund's reported performance is consistent with its stated strategy and whether the fund of hedge funds' manager appropriately comprehends the sources of the returns and potential risks.

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.

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, depository, 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 process⁷ (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 underlying hedge funds pursuant to its due diligence procedure have been satisfied, and, to the extent to which they have not, the fund of hedge funds' manager should be satisfied that, and be in a position to explain why, such deviation was appropriate in the circumstances.

⁷ This means that any decision should be made pursuant to a checks and balances process.

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; and
- b) consider to what extent the outsourcing of due diligence is consistent with the IOSCO *Principles on Outsourcing of Financial Services for Market Intermediaries*⁸.

⁸ *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>.

Feedback statement of the responses received in relation to the consultation on the Proposed Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices

Introduction

1. Following the conclusions of its report on *Funds of Hedge Funds* dated June 2008⁹, the Technical Committee developed guidelines in the particular areas where it had identified additional investor protection regulatory issues in the fund of hedge funds field 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 used by funds of hedge funds' managers prior to and during investment.
2. The purpose of these guidelines was both to address the issues as identified in the June 2008 report, and to complete the principles provided for in the IOSCO Technical Committee's report on *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds*, published in February 2003¹⁰.
3. On 6 October 2008, the IOSCO Technical Committee publicly released a consultation report providing for the aforementioned guidelines and entitled *Proposed Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices*. The IOSCO public consultation ended on 30 January 2009¹¹. For the purpose of this paper, the guidelines proposed in the IOSCO consultation report will be referred to as the *funds of hedge funds' general principles* or as the case may be, the *general principles*.
4. The purpose of this feedback statement is to present the main comments and questions raised in the submissions received in relation to the IOSCO public consultation on the funds of hedge funds' general principles.

General overview

5. Fourteen respondents¹² provided comments in relation to the funds of hedge funds' general principles. These submissions were considered by the TCSC5 at its meeting of 11 and 12 March 2009. The profile of the respondents ranged from leading industry associations (which constituted the vast majority of respondents), to investment managers and a securities regulator.

⁹ *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>.

¹⁰ *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>.

¹¹ The period of the IOSCO public consultation was extended until 30 January 2009 (in lieu of 5 January 2009 as had been initially determined) so as to enable respondents to take into consideration and reflect the most recent events in their comments.

¹² The list of the fourteen respondents to the IOSCO consultation is provided in appendix 1 hereto.

6. From a global perspective, the vast majority of respondents to the consultation welcomed and strongly supported the IOSCO work on funds of hedge funds. A few respondents also described the IOSCO work as being excellent and valuable.

7. Most respondents agreed with the funds of hedge funds' general principles on the ground that they were globally sensible, appropriate and proportionate.

8. Several respondents specifically confirmed the importance and relevance of the two areas on which the funds of hedge funds' general principles were focused, that is to say the liquidity risk management, and the due diligence process used by funds of hedge funds' managers prior to and during investment.

9. Most respondents further confirmed that the performance by funds of hedge funds' managers of stringent and robust due diligence (providing notably for appropriate safeguards and disclosures, and excluding any *ticking the box* exercise) was an essential part of adequate investor protection which, in light of the Madoff affair, had to be given appropriate prominence¹³. It was added that this was all the more true as funds of hedge funds constituted the primary vehicle through which retail investors or more risk-averse institutional investors, had access and gained exposure to hedge funds (as previously stressed in the aforementioned IOSCO June 2008 report on *Funds of Hedge Funds*).

10. Several respondents stressed that the IOSCO work was particularly timely notably in the context of the financial crisis where hedge funds had been put under scrutiny by policy makers and markets from both the efficiency and investor protection perspectives, and which highlighted the need for international standardization of the regulatory requirements notably in terms of risk management (e.g., the due diligence procedures in relation to investments in hedge funds).

11. A respondent indicated favouring a principles-based approach as far as funds of hedge funds' regulation was concerned for it to be flexible to the industry's changes and developments.

12. A respondent further emphasized that transparency was a key feature of robust due diligence and liquidity management in particular, for the fund of hedge funds' manager to better assess the suitability of a hedge fund, and for the investors to be in a position to evaluate the objectivity of the manager's decisions.

13. Another respondent stressed that the management of funds of hedge funds demanded substantial due diligence, both before and during the investment period, and both from a quantitative and a qualitative perspective, and therefore required considerable resources (e.g., research, operational) on the part of funds of hedge funds' managers. Hence, he suggested that regulators not grant licenses to firms to manage funds of hedge funds where those firms did not have the required resources and capabilities in relation thereto.

14. A respondent encouraged IOSCO to further scrutinize the due diligence process in relation to investments in hedge funds for this process not to be exclusively destined for funds of hedge funds' managers, and to be also aimed at other types of investors in hedge funds such as insurance companies or pension funds.

¹³ A respondent indicated that the Madoff affair was a very good illustration of the importance of robust and stringently applied due diligence which enabled many funds of hedge funds' managers to avoid exposure to the Madoff risk.

15. Finally, a few respondents recommended that the IOSCO work take into consideration the *level playing field* issue notably in order to maintain fair product competition¹⁴, and suggested for this purpose that IOSCO could undertake a study on the different levels of disclosure to investors across the various jurisdictions and structures of funds of hedge funds. While acknowledging that the *level playing field* question was an important one which had previously been raised in responses to the various IOSCO consultations, the TCSC5 nonetheless considered it was not relevant to address it, at this stage, given that it was not specific to funds of hedge funds and therefore required to be examined from a wider perspective.

Specific comments

- **With regard to the methods by which funds of hedge funds' managers deal with liquidity risk:**

16. Many respondents indicated being globally supportive of general principles I.1, I.2, I.3 and I.4 pertaining to the management and on-going monitoring of the liquidity risk associated with funds of hedge funds' investments. One respondent, though, considered the aforesaid general principles to be a *bit weak*.

17. Two respondents insisted that general principle I.1 regarding the verification of the consistency of the fund of hedge funds' liquidity with that of the underlying hedge funds was key to the sound management of liquidity risk and therefore to retail investors notably for the purpose of meeting their redemption requests.

18. With regard to the disclosures pertaining to limited redemption arrangements (as provided in general principle I.3 (a)), many respondents confirmed that such arrangements should be highly transparent, and therefore clearly and prominently documented in the funds of hedge funds' prospectuses for investors to be aware of these arrangements prior to subscription.

19. With regard to the aim of limited redemption arrangements, several respondents agreed that such arrangements were a very useful and common tool for the purpose of managing liquidity (in particular, in the case of funds of hedge funds whose investments were generally more illiquid than those of traditional collective investment schemes), and of protecting investors' interests (in particular, those investors who did not redeem their units). A respondent added that in this regard, these arrangements should be flexible subject to clear disclosure to investors.

20. While several respondents considered that the circumstances under which limited redemption arrangements were to be activated might not necessarily be exceptional, on the contrary, some other respondents insisted that the said arrangements should, for the purpose of investor protection, only be implemented in exceptional circumstances (as provided in general principle I.3 (b)), for a limited period, and only as a last resort. Considering that the exceptional circumstances under which limited redemption arrangements might be imposed were, in practice, the most difficult to predict and therefore to describe in the prospectuses, a respondent proposed in this respect that funds of

¹⁴ For the purpose of illustration, a respondent referred to the competition distortion related to structured products and UCITS funds (*i.e.*, collective investment schemes created under and governed by European Council directive n° 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities).

hedge funds' managers be entitled to rely on generic language. Another respondent indicated that a definition of the term *exceptional* could be helpful so as not to consider every event as exceptional.

In consideration of the above-mentioned comments and of the TCSC5 members' respective experiences in the field, the TCSC5 decided to slightly amend general principle I.3 (b) in particular to specify that limited redemption arrangements should only be activated for a limited period of time, and that the exceptional situations under which they could be activated were to be clearly stated (as opposed to defined) in the fund of hedge funds' prospectus. However, the TCSC5 did not consider it appropriate, at this stage, to provide for a specific definition of the term "exceptional".

21. The condition pursuant to which the decision to activate limited redemption arrangements be taken on a collegial basis¹⁵ (provided the size of the fund of hedge funds' manager allows it) raised both supportive¹⁶ and non supportive¹⁷ comments on the part of the respondents. The respondents which supported the collegial decision making condition (as found in general principle I.3 (c)), further proposed that the depositary's opinion or advice could be sought for the purpose of the decision regarding limited redemption arrangements where time allowed. A respondent even suggested that the depositary participate in the collegial decision making notably for it to determine whether the contemplated decision complied with the terms of the prospectus. This respondent also recommended that the investment committee referred to in the definition of *collegial basis* include representatives of fund investors.

The TCSC5 agreed to keep general principle I.3 (c) unchanged considering that the above-mentioned comments were too specific to cover the various types of funds of hedge funds' structures worldwide (notably as regards funds of hedge funds' depositaries).

22. With regard to the agreements entered into between any underlying hedge fund and any investors for the purpose of providing for preferential or more favourable rights to certain investors (as referred to in general principle I.4), a respondent proposed to ask the fund of hedge funds' manager to disclose, where possible, the nature of these agreements and the conclusions drawn thereon regarding their potential impact on the fund of hedge funds so as to enable investors to have the necessary information to evaluate the objectivity of the said manager's decisions. On the other hand, a respondent proposed to qualify general principle I.4 on the ground that the fund of hedge funds' manager might not always be aware of arrangements between the underlying hedge funds and other investors.

In light of the above-mentioned comments and of the TCSC5 members' respective experiences in the area, the TCSC5 decided to slightly amend general principle I.4 notably to provide that not only should the fund of hedge funds' manager consider the impact of the aforesaid agreements, it should also disclose the existence of such agreements if they do materially affect the fund of hedge funds' interests.

¹⁵ 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.

¹⁶ In particular, a respondent recommended that the decision as to whether and when to set up a limited redemption arrangement be made by the fund of hedge funds' board.

¹⁷ For the purpose of illustration, a respondent indicated that this condition could create different standards depending on the size of the fund of hedge funds' manager to the detriment of larger managers, as smaller managers would be allowed to operate differently.

23. A few respondents suggested to include in general principles I.1 to I.3 references or, as the case may be, conditions pertaining to the fund of hedge funds' reporting on liquidity, maximum exposures to underlying hedge funds (e.g., maximum number of hedge funds exposed to, maximum percentage of assets exposed to a single hedge fund, limit on exposure to hedge funds using the same strategy), exposure to OTC instruments, and short positions. The TCSC5 did not consider that the incorporation of the suggested references or conditions was appropriate nor relevant for the purpose of the general principles given that they mainly related to the funds of hedge funds' investment strategies and policies.

- **With regard to the nature and the conditions of the due diligence process used by funds of hedge funds' managers prior to and during investment:**

24. It is noteworthy that many respondents indicated fully endorsing and/or stressed the heightened relevance in the current context of the general principles related to the due diligence process used by funds of hedge funds' managers prior to and during investment, and in particular, general principles II.1 (a), II.1(b) 4, II.1(b) 6, II.1 (b) 7, II.1 (b) 9, II.1 (b) 10, II.1 (b) 12, II.1 (b) 14, II.1 (c), and II.2 (a) 1.

25. With regard to the recommendation that the due diligence procedure of a fund of hedge funds' manager relies on existing professional codes or guidelines published by established industry associations (as provided in general principle II.1 (a)), a respondent recommended the use of due diligence questionnaires prepared by industry associations and *accepted/acknowledged* by financial regulators.

The TCSC5 decided not to follow this suggestion notably considering that, in practice, most codes (including questionnaires) published by established industry associations are not "endorsed" per se by regulators.

26. With regard to the due diligence review of the expertise, experience and qualifications of the underlying hedge fund's portfolio managers and other service providers (as set out in general principle II.1 (b) 9), a respondent recommended that such review include an assessment of the personal integrity of the individuals in question.

In light of this comment and of the TCSC5 members' respective experiences in the field, general principle II.1 (b) 9 was slightly amended so as to provide that the fund of hedge funds' manager should also consider whether the underlying hedge fund's portfolio managers and other service providers have been held liable for breaches of applicable law and/or professional rules or standards, and have as result been subjected to sanctions (notably disciplinary ones).

27. With regard to the consideration as to whether the underlying hedge fund complies with the IOSCO *Principles for the Valuation of Hedge Fund Portfolios*¹⁸ or with valuation principles of established industry associations (as provided in general principle II.1 (b) 10), a respondent suggested to remove from the said general principle all references to the specific valuation principles and to refer instead to valuation principles meeting general industry standards, on the ground that underlying hedge funds might be *established in countries not represented at IOSCO or by an established industry association*.

¹⁸ *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>.

The TCSC5 decided not to amend general principle II.1 (b) 10 given that, on the one hand, a hedge fund being domiciled in a country not represented within IOSCO or by an established industry association, is not prevented from complying with the valuation principles set out by IOSCO in November 2007 or by an established industry association, and that, on the other hand, the absence of clear references to valuation principles would make the general principle incomprehensible and therefore unenforceable in practice.

28. A respondent insisted that the consideration by the fund of hedge funds' manager of the adequacy of the underlying hedge fund's investment strategy (as provided in general principle II.1 (b) 13), required an understanding of the leverage used in relation thereto.

For the purpose of clarification, the TCSC5 complemented general principle II.1 (b) 13 to emphasize that the review of the adequacy of the underlying hedge fund's investment strategy did include that of the type and level of leverage used by the underlying hedge fund.

29. A few respondents suggested to include in general principles II.1 (a) and (b), some references (notably as regards related party interest, the firm's control culture, the appropriateness of the pricing process, the underlying hedge fund's standards to prevent conducts against the market).

The TCSC5 did not incorporate the suggested references in general principles II.1 (a) and (b) as it considered that the said references were already covered and provided for in the general principles.

30. The identification of the risks through a collegial decision-making process¹⁹ (provided the size of the fund of hedge funds' manager allows it) as provided in general principle II.2 (a) 2, was globally approved by the respondents. Only one respondent suggested to remove the reference to the collegial decision-making process on the ground that it could create different standards depending on the size of the fund of hedge funds' manager to the detriment of larger managers, as smaller managers would be allowed to operate differently.

In light of the TCSC5 members' respective experiences in the area, the TCSC5 decided to keep general principle II.2 (a) 2 unchanged.

31. A respondent proposed that in the event the fund of hedge funds' manager determined that the principles used to select eligible underlying hedge funds under its due diligence procedure had not been complied with, it should determine whether and be satisfied that such deviation was appropriate in the circumstances.

For the purpose of further securing the due diligence process of the fund of hedge funds' manager and in light of the TCSC5 members' respective experiences, the TCSC5 decided to incorporate the above-mentioned comment in general principle II.2 (b).

32. With regard to the outsourcing by a fund of hedge funds' manager of any part of its due diligence as provided in general principle II.3, a respondent proposed to subject such outsourcing to additional conditions (such as the establishment of a clear written mandate defining the role and responsibilities of the parties).

In consideration of the specific conditions proposed by this respondent, the TCSC5 decided not to expressly incorporate them in general principle II.3 as most if not all of the suggested conditions

¹⁹ This means that any decision should be made pursuant to a checks and balances process.

were already covered and provided for in the general principle in particular, through the reference to the IOSCO *Principles on Outsourcing of Financial Services for Market Intermediaries*²⁰.

33. Finally, a respondent indicated that the fund of hedge funds' manager could not in practice comply or could face difficulty in complying with a few general principles (in particular, general principles II.1 (b) 2, 3, 11, 12, 13, 14, 16), notably because the information mentioned in the general principles might be difficult to obtain.

In this regard, and in light of the other respondents' comments, and of the TCSC5 members' respective experiences, the TCSC5 considered that in practice, reasonable enquiries could enable funds of hedge funds' managers to obtain the useful and relevant information for the purpose of making the determination provided in the general principles in question.

Conclusions

34. In light of the respondents' main comments as described in this feedback statement, and further to its discussion at its March 2009 meeting, the TCSC5 issued a new and final version of the funds of hedge funds' general principles. This new version mainly includes amendments in relation to general principles I.3 (b), I.4, II.1 (b) 4, II.1 (b) 9, II.1 (b) 13, and II.2 (b).

35. The TCSC5 further decided to submit the final version of the funds of hedge funds' general principles along with this feedback statement, to the Technical Committee at the latter's June 2009 meeting for its approval.

²⁰ *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>.

Appendix I:

List of the 14 respondents to the consultation

Name	Jurisdiction
Association for Savings & Investment SA (ASISA)	South Africa
Association Française de la Gestion Financière (AFG)	France
The Alternative Investment Management Association Limited (AIMA)	UK
Bundesverband Alternative Investments e.V. (BAI)	Germany
Centre for Financial Market Integrity (CFA Institute)	UK
European Fund and Asset Management Association (EFAMA)	Belgium
HDF Finance	France
International Banking Federation (IBFed)	UK
INVERCO (Spanish Association of Collective Investment Schemes and Pension Funds)	Spain
Investment Management Association (IMA)	UK
Irish Funds Industry Association (IFIA)	Ireland
Superintendencia Financiera de Colombia	Colombia
Thames River Capital L.L.P.	UK
VÖIG (the Austrian Association of Investment Fund Management Companies)	Austria