

Guide to Sound Practices for Funds of Hedge Funds Managers



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Chairman's Letter

The Guide to Sound Practices for Funds of Hedge Funds Managers is an initiative that AIMA commenced work on last year. Whilst AIMA has published several Guides to Sound Practices this is the first for Funds of Hedge Funds Managers and is aimed at, primarily, investors, managers, advisors and other stakeholders. The Guide sets out clear recommendations for sound practices in the following areas:

- ≈ Creating and Managing a Funds of Hedge Funds Business
- ≈ Investment Process and Portfolio Risk Management
- ≈ Administration and Operations
- ≈ Raising Capital and Investor Relations
- ≈ Fund Structures and Governance

The members of the Steering Group for this Guide are volunteers who were purposefully selected for their global profile, which has ensured that the Guide offers its readers a far-reaching perspective on the many issues that should be considered by a Funds of Hedge Funds business. Naturally, it would be impossible to capture every varying approach and idiosyncrasy associated with different regions and countries that Funds of Hedge Funds operate from. This is why the Guide is not intended to set out definitive standards nor is it an exhaustive list of requirements that could serve as a benchmark against which conduct should be assessed.

The familiar adage that there is no substitute for professional advice still applies in managing a Funds of Hedge Funds business, along with the equally familiar statement that this Guide should not be taken or treated as a substitute for specific advice, whether legal or otherwise. To illustrate this, the final chapter is dedicated to Fund Structures and Governance but it does not seek to provide advice on wider ranging corporate governance issues, where a legal opinion is invaluable.

I, and my colleagues on the Steering Group, believe that the Funds of Hedge Funds business model remains valuable for many hedge funds investors and therefore this Guide will provide a useful starting point for new participants, as well as a reference for existing members of our community. A great deal of work has gone into the Guide and we feel that the timing and recommendations are particularly pertinent given that the markets have been in crisis.

It has been my pleasure to chair this Group and I would like to thank the participants (listed in the Appendix) for their time and hard work, particularly during such a challenging period in the industry.



Patrick Fenal
Chief Executive Officer
Unigestion

Disclaimer

The Guide is not to be taken or treated as a substitute for specific advice, whether legal advice or otherwise. It does not seek to provide advice on any of the issues herein. The views expressed in this Guide are those of AIMA and do not necessarily represent the views of all of the participants of the Steering Group.

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Introduction

Funds of Hedge Funds are precisely that, portfolios which have a mandate to invest in hedge funds. That mandate may dictate a level of diversification across different hedge fund strategies or, as is less commonly seen, it may require a portfolio to focus on one specific theme. The world's first Fund of Hedge Funds was launched in 1969 by Banque Edmond de Rothschild, some 20 years after the first single hedge fund was established in the USA by Alfred Jones. Despite a 40 year presence, reliably recorded data for Funds of Hedge Funds only commenced in 1990 when there were 31 in existence with approximately USD 1.8 billion under management compared to the end of 2008 where there were about 3,000 Funds of Hedge Funds managing USD 593 billion of the USD 1.4 trillion assets in the hedge fund industry. Funds of Hedge Funds were the largest investor in hedge funds at the peak in mid-2008, with a market share of about 45%.¹

Although there are many reasons for investing in hedge funds they would not be a conceivable proposition if the risk-adjusted returns were not attractive. In a Guide such as this, the recent and current events of the crisis in the financial markets and their effect on the hedge fund industry cannot be brushed over. Ignoring the commentators who mistakenly blame hedge funds for the entire collapse of the financial markets and any other vaguely related issues, there is clear evidence to support their continued presence in a portfolio for investors with a long-term outlook.

The compound annual rate of return of the HFRI Fund of Funds Composite Index was 8.1% for the period from January 1990 to January 2009, whereas equities compounded at 4.2% and bonds at 7.0% during the same period.² The average return of the NASDAQ from 1999 to 2008 was 3.2% with a volatility of 28.9%, whereas the figures for the same period for Funds of Hedge Funds show average performance of 6.1% with a volatility of 6.7%.³ These figures (all in USD terms) suggest that on a long-term basis, investing in hedge funds remains a compelling proposition.

Assuming that a qualified investor has decided that an exposure to hedge funds can provide it with the portfolio diversification, risk adjusted returns and downside protection that hedge funds offer, then he or she will need to understand how to access this. The sometimes high initial investment amounts, capacity constraints of the more popular hedge fund managers, restrictive lock-ups, not to mention the high costs and specialist skills, undoubtedly, required in selecting hedge funds for investments are high barriers to entry for some potential investors. Funds of Hedge Funds management companies are businesses whose sole focus is to conduct thorough due diligence on their underlying investments to achieve adequate risk-adjusted returns and they can sometimes obtain better terms and transparency than most of the largest direct investors into a hedge fund.

There has been much commentary on the decline in performance and, in turn, assets under management that the Funds of Hedge Funds industry has experienced in 2008. Redemptions have been caused, partially, by the poor performance of hedge funds during 2008, with the HFRI Fund Weighted Composite Index falling by 18.3%. However, this performance should be observed within the context that this was only the second calendar-year decline since 1990.⁴ As discussed above, historical data has shown that over the long-term, hedge funds still provide stable risk adjusted returns. Funds of Hedge Funds managers who have the

¹ Source: hedgefund.net

² Source: A&Q Industry Research

³ Source: A&Q Industry Research, Thomson Financial

⁴ Source: Hedge Fund Research, Inc



tools to actively manage risk and utilise a flexible approach to investment management should be the choice for investors during times of volatility and uncertainty in financial markets.

As a result of stronger competitive pressures Funds of Hedge Funds businesses have a responsibility to their investors to seriously scrutinise and reassess their systems, risk management and due diligence processes. This Guide addresses the main issues involved in creating a robust Funds of Hedge Funds business that has repeatable investment performance and strong risk management processes.

In a world where there are currently, approximately 3,000 Funds of Hedge Funds, the majority of whose management companies are located in the USA, United Kingdom and Switzerland, it may seem that this is already a crowded market place.⁵ However, even in troubled times, opportunities abound and a survey conducted in January 2009 by Prequin, with over 50 institutional investors to gauge their attitudes to the hedge fund industry, revealed substantial positive sentiment. Key findings of the survey revealed that 77% of respondents remained confident and would continue to invest. Of that, 26% would increase their allocation during 2009. 15% stated that they are less confident about hedge funds but would continue to invest while 8% of investors stated that they are no longer confident and would reduce their investments.⁶ Further positive findings have emanated from a white paper published by The Bank of New York Mellon and Casey Quirk, in April 2009. It forecast that Funds of Hedge Funds will continue to be the primary hedge fund distribution channel, capturing almost 60% of new flows between 2010 and 2013. It added that Funds of Hedge Funds could oversee close to 50% of total hedge funds assets in 2013, compared with 36% in 2005 and 17% in 2000.⁷ The result of this means that there is still space for talented individuals and, traditionally, the hedge fund industry has been a home for entrepreneurs and innovative thinkers. New entrants will need to understand what they can add to the industry, whether it is a strong investor following, access to particular managers or even a particular expertise in niche investment strategies.

Starting any business can be a complicated and involved process. This Guide should act, at the very least, as a route map for new Funds of Hedge Fund managers and a 'health check' for existing ones. This Guide should be read and followed in conjunction with advice and counsel from industry professionals, as recommended throughout. Some of the details may change depending on the jurisdictions in which both the Fund of Hedge Funds management business is located as well as its funds. The sentiment, however, remains the same throughout - a Funds of Hedge Funds business should be set up and run ensuring that sound practices are utilised throughout all the different functions. The managers of the business have a fiduciary and regulatory responsibility to ensure that their clients' money is being managed professionally, legally and with adherence to any mandates that have been set out. One could go as far to say that despite being paid for the privilege, being given the responsibility of looking after other's money, whether it is a large endowment, pension fund or small family office, it is still a privilege and should be viewed as such.

⁵ Source: hedgefund.net

⁶ Source: Prequin Survey Results: The Institutional Investor Outlook for 2009 (February 2009)

⁷ Source: The Bank of New York Mellon and Casey Quirk Analysis 2009



1. CREATING AND MANAGING A FUNDS OF HEDGE FUNDS COMPANY

The Guide assumes that the establishing of a Funds of Hedge Funds Management Company (“FoHF ManCo” hereafter) is for the medium and long term and involves creating and managing a viable business. FoHF ManCos are fiduciaries and must act in the best interests of each of their clients, at all times, and in compliance with the principles, rules and regulations prevailing in the jurisdictions in which they operate.

The principals of the FoHF ManCo, as the proprietors and/or controllers of a financial services business, are responsible for all aspects of that business and should give due consideration to the business risks involved at the start and throughout the life of the business.

This chapter considers an outline of the requisite management systems and controls pertinent to a FoHF ManCo. It does not extend to investment management or client management processes, each of which are addressed separately in subsequent chapters. It emphasises the importance of strong procedures and controls, segregation of potentially conflicting duties, the management of business risks and the need for skilled and experienced personnel, whether or not on an employed or externally retained basis.

1.1 Creating a Funds of Hedge Funds Management Company

Typically, most FoHF ManCos are small, at least at the outset, and are likely to be supported and/or advised by a number of service providers such as administrators, custodians, compliance consultants, systems providers, hedge fund consultants, book-keepers, tax advisors, accountants and lawyers. This can give the management team the ability to use highly specialised and skilled resources without needing to build such support in-house at the outset.

There are a number of considerations which the principals of the FoHF ManCo need to address when setting up their business. These include:

- a. market opportunity for their products, which often defines the business opportunity;
- b. investment strategy(ies) and research;
- c. marketing strategy and capital raising;
- d. business strategy and its short, medium and long term goals;
- e. management team and staffing requirements;
- f. ownership and funding of the FoHF ManCo entity;
- g. legal and tax structure of the FoHF ManCo entity and the fiscal needs, including those of the principals;
- h. regulatory requirements;
- i. operating infrastructure and systems;
- j. service providers;
- k. financing counterparties;
- l. risks and sensitivities;
- m. margins, financial forecasts, break even analysis, budgets and milestones;
- n. sources and quality of seed finance and any issues relating to ownership associated with this; and
- o. client service approach and reporting.



It is important to seek advice from competent and experienced professional advisors in many of these areas to reduce or eliminate the business risks involved in setting up a new venture. Many issues will not be unique to a particular FoHF ManCo and so experienced professional advisors should quickly be able to identify appropriate solutions. For example, the structure and manner of operation of the management company should not only be tax efficient and flexible but should also be cost effective and easy to implement. The principals will need to consider their personal tax positions as well as that of the FoHF ManCo.

Principals will find it useful to address these matters in a business plan. The business plan can then be used to ensure that investments in people, technology and infrastructure are appropriately aligned with each other and with the overall objectives of the business. The plan should reflect realistic growth scenarios and sensitivities should be tested. It should be used to determine the long term capital, working capital and regulatory capital requirements. It should consider the introduction of new partners or principals, realisation strategies and potential exit routes. When a firm is seeking authorisation from a regulator, such as the Financial Services Authority (FSA), these documents normally form the basis of its application.

1.2 Managing a Business

Business management involves a set of competencies and responsibilities which are generally distinct from trading or portfolio management. Business management, sales, trading and portfolio management skills are rarely fully developed in any single individual and, if they were, the individual concerned might find him or herself short of time to exploit them all efficiently. Decisions, therefore, need to be made as to how the business will be organised and managed and how the principals will divide or delegate their responsibilities.

1.3 Management and Controls

Every FoHF ManCo, whatever its size, should organise its internal affairs in a responsible manner, ensuring it has appropriate systems, procedures and controls designed to mitigate and manage the risks to which the business is subjected. These should be documented but the extent of documentation will vary depending on the complexity of the business operations. The FoHF ManCo may want (or be required by its local regulator) to document its internal organisation arrangements using an organisation chart to identify those employees involved in each business process as well as the relationships with external providers.

On the assumption that the business has a chief executive and a chief investment officer as part of its initial team, they should properly consider the importance of appointing an appropriately qualified individual, typically known as a chief operating officer, as early as possible to deal with operations, risk, finance and compliance issues. The more complex and larger the business is, then the more likely these functions will need to be segregated amongst personnel. The chief operating officer should be furnished with sufficient authority as he or she will be instrumental in dealing with a number of counterparties through the start-up phase, designing systems and procedures and ensuring the business is properly structured and financed.

Management should implement a business risk management process to assess all the non-investment risks associated with the business, although the degree of formality of this process will vary widely depending upon the regulatory environment and the size and complexity of the business. The risk management process would typically encompass:



- a. identification of the key risks facing the business across all areas, including risks such as reliance on key clients or investors, reliance on key staff and access to sufficient capital. The risk analysis should also consider “what if” scenarios for the business and management should anticipate how they might react and stress testing should be performed;
- b. formal risk assessment of the business should be carried out which should include the review of stress scenarios. This assessment should be viewed as a dynamic process but should be carried out no less frequently than on an annual basis and should be approved by senior management. This process should be documented (whether formally or informally). In some jurisdictions, regulators require this risk assessment to be completed and documented, and for the FoHF ManCo, formally, to consider the regulatory capital implications of the risks that are being taken;
- c. implementation of controls to mitigate those risks. For each risk, management should determine whether to accept the risk and mitigate it through controls or to avoid it. Suitable personnel should be identified to own and effectively monitor controls. Controls should be embedded in normal business processes;
- d. design of a monitoring process to ensure effectiveness of those controls. Management should ensure that any internal or external monitoring exercise includes a review of the key risks; review of the control design and any change in risks;
- e. reporting to senior management on both the effectiveness of controls and the changing risk profile of the business; and
- f. effective controls to ensure that any significant weaknesses are reported to senior management as soon as they are detected and relevant personnel are assigned responsibility for rectification of these weaknesses.

If the management team has no direct experience of certain business risks and controls within their sphere of responsibility, as a risk management tool, the firm should seek to obtain independent advice or conduct a review of the relevant processes.

1.3.1 Appointment of Dedicated Service Providers

Where key functions are delegated, management must be satisfied as to the competency of the relevant service provider and should have a process in place to monitor and review work performed. The business can delegate functions, but it cannot delegate its responsibilities. Such a process may include initial consideration of a number of external service providers against a set of agreed criteria and thorough due diligence, prior to selection and, thereafter, would involve *inter alia*:

- a. assessment of performance against contractual or agreed service standards normally enshrined in a service level agreement (“SLA” hereafter);
- b. periodic performance review meetings; and
- c. comparison of actual performance against the agreed service standards benchmarks.



The firm should ensure that it undertakes suitably robust monitoring reviews of the third parties to provide itself with the assurance that they are performing the delegated functions in accordance with their SLAs. In addition to reviewing service levels on an ongoing basis, the FoHF ManCo should periodically review the business status of the service providers, e.g., ownership structure, capital and client base, strategic plans etc.

1.3.2 Segregation of Duties and Allocation of Tasks

One of the strengths of a FoHF ManCo can be the close involvement of the principals in the day-to-day affairs of that business. Conversely, it can represent a weakness if the FoHF ManCo is unable to apply the “four eyes” principle to investment decisions and key management controls. In a situation where it is not possible for the firm to apply the “four eyes” principle, it should consider alternative methods of obtaining this assurance, for example, by the use of specialist external consultants. However, when setting up a FoHF ManCo, the scale of resources should be assessed to ensure that the business can be established in a genuinely professional manner.

It is essential for good business practice to segregate, amongst different personnel, duties which may be regarded as incompatible with each other. Examples include, initiating and approving investment and cash transactions and monitoring portfolio risk. However, this is often difficult to achieve in FoHF ManCos with a limited number of employees. There are some basic steps which can be taken to help reduce the risks. These include, ensuring that key transactions, particularly those related to cash, are approved by two people in appropriate positions of authority and using the control systems and procedures of service providers to verify and oversee transactions. In broad terms, at the very least, there should be a clear distinction between front and back office functions and these should not be conducted by the same people.

1.4 Finance

1.4.1 Systems and Accounting Records

Firms should ensure that they have appropriate systems and procedures capable of:

- a. developing relevant budgets, including cash flow forecasts;
- b. monitoring their financial resources and liquidity position;
- c. producing timely and accurate management accounting and financial information; and
- d. providing necessary regulatory and statutory financial reports in the format that the jurisdiction requires.

In the case of a., budgets should be prepared annually and updated where significant changes occur in underlying assumptions. These should include monthly income, expenditure, cash and (if relevant) regulatory capital forecasts. The assumptions within the budget should encompass all expected additional costs, e.g., increased reward to existing personnel, anticipated staff hires or changes in operational processes or location.

Procedures in respect of the processes adopted for each of a. to d. above should be documented and retained.

Client reporting which may, for smaller firms, reside within the finance function, is outside the scope of this chapter (see chapter 4) but the importance of accurate, timely, fair and consistent client reporting cannot be overemphasised.



1.4.2 Regulatory Financial Resources

Management should have the appropriate knowledge and skills to monitor the financial resources position of the business and to complete relevant regulatory financial filings. In different jurisdictions, minimum capital requirements vary significantly. Minimum capital requirements may apply to portfolio managers themselves or to the FoHF ManCo. When minimum regulatory capital requirements are in place, they are often based on a percentage of forecast expenditure or a proportion of assets under management. Financial regulations in many European jurisdictions often dictate the manner of computing financial resources for these purposes. Where relevant, a FoHF ManCo should be capitalised in order to meet the minimum regulatory capital requirements with some contingency (most FoHF ManCos will have an excess of at least 10 to 20% over the amount that they are required to hold) to take account of future changes and unexpected developments. FoHF ManCos should ensure that the regulatory capital is invested in assets that the regulator, in the relevant jurisdiction, deems suitable. Investors should assess the capital adequacy of FoHF ManCos on the basis of a proportion of assets under management, as well as relative to the annual fixed costs.

In some jurisdictions, regulators also require regular financial information on the FoHF ManCo and the FoHF ManCo group, including group capital adequacy returns.

1.5 Compliance

Compliance within a FoHF ManCo should be viewed as two separate risks, “regulatory” and “non-regulatory”. The former will emanate from the business being authorised by a regulatory body and the consequent obligation to adhere to regulatory rules and principles. The latter results from the investment and risk control processes developed to run the business and these can vary amongst different FoHF ManCos. Compliance is a key function for investment businesses and it should be noted that MiFID places strong emphasis on this, including the requirement that a compliance officer should be appointed.

Typically, a FoHF ManCo will need to have its business authorised or licensed by a local regulatory body. Gaining authorisation or a license can be a time-consuming and complex process; obtaining and retaining the correct authorisations for the business which the FoHF ManCo intends to operate is essential. Unless the FoHF ManCo has the required in-house experience, professional advice should be sought to guide it through any initial registration process. Should the firm decide to adopt this route then it needs to ensure that it is fully conversant with the information included in its documents because, as part of the application process, individuals in the firm may be questioned by the regulator.

The FoHF ManCo should also ensure that if any new business activity is planned, the compliance and internal resource requirements are understood and are in place prior to commencing that business.

A FoHF ManCo should ensure that it understands the regulatory environment within which it operates and the specific rules applicable to its business. A FoHF ManCo should develop procedures to comply with these rules and to meet the fiduciary responsibilities of the Funds of Hedge Funds (“FoHF” hereafter) and those of the FoHF ManCo. The FoHF ManCo should additionally ensure that all members of staff are fully aware of the procedures and rules applicable to their particular area of work. This can be achieved by initial and ongoing employee compliance training and by creating a written compliance manual setting out policies on key areas such as investment and trading, code of ethics on personal dealing, market abuse (including insider dealing), and conflicts of interest and other regulatory matters



that impact the business. When new policies are implemented, the manual should be updated accordingly. Some firms may decide to supplement the compliance manual with written procedures for specified processes. The compliance manual should be reviewed and maintained as a “living” document and updated to reflect both changes that occur at the firm and any changes to applicable laws or regulations. Clear distinctions within the manual should be made between the regulatory and non-regulatory aspects of compliance functions.

An up-to-date, hard copy of the manual should be given to every member of staff, annually, who should sign a form acknowledging that they have read it and shall adhere to its rules. The manual should be updated on the company’s corporate intranet, and major changes would require the signatures of employees, outside the mandatory annual process. These major changes should be communicated to employees by the compliance function, with an explanation of how the changes will impact roles and procedures.

1.5.1 Compliance Function

The FoHF ManCo should appoint a senior individual to take responsibility for compliance oversight. The person responsible for compliance oversight will have a duty to help and advise senior management and employees in ensuring that they comply with their own and the firm’s regulatory responsibilities. They will therefore need to keep up-to-date with regulatory changes, whether those changes are actual or proposed.

The FoHF ManCo should ensure that this individual has sufficient time to dedicate to the task and that recurring tasks, such as record keeping and compliance monitoring, are completed on a timely basis. He or she should be vested with the necessary authority to enforce compliance with relevant rules and internal procedures and be granted a right of access to all relevant information and records. That individual should report directly to the chief executive or the general manager of the FoHF ManCo or, in the least, to someone whose role is independent of the day-to-day functioning of the business (i.e., not to anyone in charge of investments or operations, including valuation).

It is unusual, in smaller management companies, for the compliance officer to be full time or have a total knowledge of all rules and regulations and, where this is the case, the FoHF ManCo should put in place an arrangement with appropriate professional advisors for further advice and guidance. The compliance officer and chief executive must be involved in key compliance issues and should ensure that they provide an appropriate compliance culture in the business.

In some jurisdictions, compliance consultants assist the compliance officer to maintain the compliance infrastructure of the FoHF ManCo. The compliance officer remains responsible for the compliance arrangements of the business.

It is worth reiterating that, where a function is delegated, the responsibility remains with the senior management and governing body the FoHF ManCo.



1.5.2 Compliance Monitoring

The FoHF ManCo should implement arrangements for the monitoring of activities on a regular basis to ensure that business is conducted in compliance with regulatory requirements. Compliance monitoring will also assess whether changes in processes resulting from regulatory changes have been properly implemented. Such monitoring should include key aspects of the conduct of business. The frequency and scope of monitoring should be determined by the size and complexity of the business, targeting compliance work on those areas of highest risk. This may result in focus on the investment process and related risks but would, nevertheless, cover other aspects of the business. Typically, a FoHF ManCo should conduct a formal compliance monitoring exercise on, at least, an annual basis which may be split into monthly or quarterly elements. The results of such monitoring should be documented and there should be follow-up and reporting on actual or potential problems with management to ensure that corrective action is taken. Significant findings should be reported to the governing body. Procedures should be in place to ensure that where weaknesses have been identified, these are promptly resolved. Any person undertaking compliance monitoring must not be involved in the performance of services or activities they monitor.

1.5.3 Relationship with Regulator

FoHF ManCos should seek to retain an open and co-operative dialogue with their regulator, in each jurisdiction operated from, either directly or through a trade association such as AIMA.

1.6 Employees

Typically, FoHF ManCos employ small teams of specialised professionals who are highly committed and who are known to each other. Nonetheless, management should be vigilant in ensuring that employees:

- a. have the requisite level of knowledge and experience for the tasks they are undertaking;
- b. are and remain competent for the work they undertake;
- c. are appropriately supervised and their competence is regularly reviewed; and
- d. are not awarded remuneration that induces excessive risk-taking.

There should be a clear policy outlining the information that employees are required to disclose regarding their personal investments. Employees should inform the compliance officer of any investments that they may have in hedge fund products.

Senior management should be aware of the dependence which can be placed upon key individuals in a small team and seek to mitigate the risks involved if one of these key individuals leaves (or is otherwise not available to) the FoHF ManCo. Where possible, the FoHF ManCo should seek to have alternates in place for all significant roles. FoHF ManCos should give consideration to purchasing professional indemnity as well as directors' and officers' liability insurance. In some jurisdictions, it is a regulatory requirement to have this insurance in place, with certain minimum levels dictated.



1.6.1 Recruitment

In order to ensure the suitability of new employees, the FoHF ManCo should have in place appropriate recruitment procedures. Typically, such procedures would include an analysis of the specific role (job description), interviewing against that job description and undertaking appropriate due diligence checks on new employees. Such due diligence checks are likely to include seeking formal references. The recruitment procedures should also comply with relevant employment law, such as equal opportunity and/or anti-discrimination legislation. Written terms of employment should be in place by the time an employee takes up an appointment. Employment may also need to be conditional upon regulatory approvals.

Some FoHF ManCos find it helpful to develop a staff handbook setting out employment policies, terms and conditions.

1.6.2 Training

All employees should undergo both induction training and continuous professional development (much of which may be informal in nature). This training should be designed to introduce the employee to the key business systems, procedures and compliance requirements and to ensure that employees remain up-to-date with the market, product developments and with changes in rules, laws and regulations.

In some jurisdictions, training is required for all relevant employees in respect of anti-money laundering and counter terrorist finance. It is important that FoHF ManCos meet their legal obligations and maintain evidence of the completion of required training.

FoHF ManCos should remain alert to the need for continued training and development of employees, particularly in rapidly changing investment environments or in cases where employees are changing or undertaking new roles.

To the extent that new instruments or hedging techniques are utilised the firm should ensure that any individuals trading such instruments are assessed as being suitably competent before any trading occurs. Likewise, the firm should ensure that it has incorporated processes and procedures to assess and control the risks associated with the use of new instruments or hedging techniques.

1.6.3 Employee Benefits

It is usual for FoHF ManCos to offer their employees certain benefits and these should be outlined in an employee handbook, together with other more general requirements. This handbook should include:

- a. healthcare benefits;
- b. pension benefits;
- c. *ad hoc* benefits, e.g., death in service cover;
- d. business hours (typically for administrative staff);
- e. holiday allowance; and
- f. bonus schemes - discretionary or non-discretionary.

Some of these benefits may require external vendors and it is the responsibility of senior management to ensure that suitable companies are hired to administer these activities.



2. INVESTMENT PROCESS AND PORTFOLIO RISK MANAGEMENT

This chapter deals with the sound practices relating to the creation of an investment process and portfolio risk management framework. Some of these practices may be very intuitive for individual portfolio managers and small teams, but it is important to recognise that investment processes evolve over time and as a FoHF ManCo grows and staff change, clear communication about the investment process, both to staff involved in its implementation and to investors, will help in the avoidance of misunderstandings and reduce the potential legal risk and risk of errors.

These processes should be tailored to individual FoHFs and the style of investment undertaken. If single investor portfolios (“SIPs” hereafter) are also operated, then the process and controls should be consistent with the commingled FoHFs (see appendix 1).

2.1 Due Diligence, Manager Selection and Monitoring

One of the goals of due diligence is to try to avoid investing in underlying hedge fund frauds or failures. The process of underlying hedge fund selection by FoHF ManCos must involve defined and thorough due diligence and all invested funds will have passed through a due diligence process. There is no precise definition of what is to be included in hedge fund due diligence and no international regulatory standard exists to specifically address due diligence or the selection of underlying hedge fund managers by FoHF portfolio managers. Some jurisdictions have rules or regulations governing certain aspects of best practice on these topics and, normally, these rules and best practices are imposed by the jurisdictions where the FoHFs are incorporated or operate and where the FoHF ManCo is domiciled. However, they typically focus on the organisational and procedural aspects, including the marketing of the FoHFs, rather than on the content of the required due diligence or manager selection process.

2.1.1 Due Diligence Steps

Due diligence is the process of gathering and evaluating information about a hedge fund manager, as well as the investment vehicle itself, in order to assess whether a specific hedge fund is an appropriate candidate for investment by a FoHF ManCo. The due diligence process can vary depending on the style of the underlying hedge funds for example, a hedge fund which employs a systematic trading strategy will require some different due diligence analysis compared to a long/short equity, research-driven hedge fund.

The due diligence process can be split into 2 time frames:

- a. prior to investing - during the selection process; and
- b. ongoing monitoring - after initial investment, during the investment period.

The due diligence process during these time frames should be a combination of both quantitative and qualitative criteria. It is essential that once an investment is made into an underlying hedge fund it is regularly monitored in order to capture any investment style drift, changes in the risk profile; changes in key management personnel and changes in the levels of transparency of large and unusual inflows or outflows of assets.



And into 5 stages:

- a. research and sourcing;
- b. strategy and investment process due diligence;
- c. operations due diligence;
- d. legal documentation analysis; and
- e. reputational checks.

The FoHF ManCo may consider the delegation of any of the above stages to an external service provider. In that situation, the FoHF ManCo should be expected to have procedures and processes in place to appropriately evaluate the service provider(s) and their compliance with industry best practice.

2.1.2 Eligibility Criteria

The thorough, and often time-consuming, due diligence process involves checking that a potential underlying hedge fund investment meets certain basic criteria, such as the following:

- a. custody of assets should be handled by an independent and financially sound entity;
- b. custody of assets should be segregated from the custodian's own assets, and/or re-hypothecated trades should be held in a segregated account in the name of the underlying hedge fund at the prime broker;
- c. independent and reputable administrator;
- d. minimum monthly valuation, by an independent third party;
- e. mandatory annual (minimum) audit of the fund accounts by independent auditors, with hedge fund expertise;
- f. independent lawyers;
- g. legally enforceable ownership rights;
- h. hedge funds should be based in reputable and well regulated jurisdictions, which have been the subject of favourable International Monetary Fund (IMF) and Financial Action Task Force (FATF) reviews;
- i. liquidity profile of underlying funds should not differ significantly to the liquidity terms of the FoHF; and
- j. adherence to industry standards such as the Hedge Funds Standard Board (HFSB).

2.1.3 Research and Sourcing

The selection process begins with the available universe of hedge funds. FoHF ManCos can select hedge funds to include in their due diligence process through a number of sources. Hedge fund databases provide a good starting point however, they do not capture the entire universe of hedge funds and the information reported on them is usually limited. Other useful sources include capital introduction teams, conferences, trade journals and industry contacts.



Screening and identification amongst the universe or peer group and the manner in which the fund was selected, either through visits, questionnaires or conference calls, should be documented. Information regarding the process of selection, how decisions were guided by information gathering, verification, qualitative and quantitative analytics and assessment, should also be documented, in a consistent format.

2.1.4 Strategy and Investment Process Due Diligence

In order to evaluate the capability of a manager to perform any investment management activities for an underlying hedge fund, the main areas requiring attention or action in the due diligence process are:

- a. quality and experience of the management team, including any key-person risks;
- b. investment strategy and associated investment research capability;
- c. evaluation of risks associated with the portfolio (e.g., leverage, concentration, counterparty selection, type of instruments);
- d. hedge funds risk management process, risk and control culture, and discipline including any risks associated with the delegation of any activity to an external service provider;
- e. process and organisation of the execution and trading;
- f. analysis of the track record of the hedge fund manager (if any); its feasibility (particularly with respect to back tests and pro-formas); its corroboration with the claimed strategy and stated risk levels; comparison to peers who operate using the same strategy; and capability to operate and perform successfully in varying market environments;
- g. quantitative analysis which may provide a systematic and independent assessment of a hedge fund manager's risk profile;
- h. review of possible conflicts of interest; and
- i. rebates (if any) provided by underlying hedge funds should accrue to the FoHF and not to the FoHF ManCo (thus ensuring the due diligence process is not influenced by financial considerations).

2.1.5 Operations Due Diligence

This is an essential element to the due diligence process and should be performed by separate personnel from the investment analysts within a FoHF ManCo. Detailed reviews of the organisation of an underlying hedge fund's management company; of any of its service providers; its technology and systems and of documents (e.g., audited statements) are undertaken in order to evaluate non-investment type risks, before an investment is made into the hedge fund investment vehicle.



The analysis includes, but is not limited to:

- a. analysis of the management company structure (such as capital base composition and review; experience of operational staff; segregation of duties; IT infrastructure; valuation process and accounting; valuation policy and corporate culture) and assessment of any associated risks;
- b. review of valuation process of OTC, illiquid or non-exchange tradable securities;
- c. review of any tasks delegated to service providers and an assessment of their ability to perform those tasks;
- d. evaluation of potential conflicts of interests at the operations level;
- e. quality and structure of the governing body;
- f. strength and reputation of the independent administrator, auditors, prime broker and custodian;
- g. custody and/or prime brokerage of hedge fund assets handled by independent entities, appropriately regulated;
- h. cash controls approval and investment;
- i. process and organisation of the execution and trading;
- j. evidence that a proper reconciliation process is in place including, at least, daily trades, cash and holdings, pending transactions and settlement processes;
- k. analysis of the life cycle of a trade, including trade input to the IT system;
- l. adequacy and appropriateness of financing arrangements;
- m. counterparty risk, including:
 - i. concentration of risk within counterparty;
 - ii. evaluation of quality and reputation of counterparty;
 - iii. re-hypothecation risk;
 - iv. conflicts of interest; and
 - v. terms of contracts between the hedge fund and the counterparty.; and
- n. disaster recovery/business continuity review.

2.1.6 On-Site Visits

In order for a FoHF ManCo to obtain a genuine understanding of an underlying hedge fund, it is essential that on-site visits take place. This offers the FoHF ManCo the opportunity to see the environment that the hedge fund is operating within. Whilst other forms of communication with underlying hedge funds managers are still valuable and necessary, there is no replacement for face-to-face meetings where reactions to questions and the general substance of the business can be observed. These on-site meetings should take place at least annually.



2.1.7 Legal Documentation Analysis

A review of the legal documents of an underlying hedge fund (offering documents, memorandum and articles of association, and all agreements with service providers, including the management/advisory agreement, etc.) should take place in order to assess issues such as:

- a. potential risks in the legal structure (e.g., lack of ring-fencing, contagion risk, inappropriate segregation of different investor classes, investors rights, side letters, fund domicile and past changes in structure) that may potentially impact investors;
- b. coherence of all the documents;
- c. legal relationship between the fund and its service providers;
- d. quality of the governing body;
- e. any potential conflicts of interests in the structure; and
- f. procedures regarding changes in liquidity terms for investors.

FoHF ManCos should establish a routine process to receive communications from hedge funds including notices to investors, as described in 3.8.1, as well as updated offering documents. As with proxy matters, changes to offering documents should be fully understood and, if inconsistent with the FoHF ManCo's expectations of the offering, the portfolio manager must speak immediately to the underlying hedge fund to gain acceptable explanations of the changes. When required, side letters also may be negotiated, for instance, in order to either clarify meaning in the legal documents, obtain better terms (i.e., tailored client reporting, fees, etc.) or to receive enhanced transparency.

2.1.8 Reputational Checks

Processes should be in place to check the background of an underlying hedge fund manager and/or of any important team members. These should include:

- a. reference checks of portfolio/investment managers by other managers/previous colleagues;
- b. background reviews by external business intelligence professionals covering: criminal activity, general relevant information etc., of portfolio/investment managers and key employees; and
- c. periodic/specific evaluation of the quality and organisation of any service providers (existing or new).

2.1.9 Procedures, Policies and Data Management

FoHF ManCos should have documented policies and procedures covering the selection and monitoring of their hedge fund investments, including elements such as strategy, business risk, operational and reputational matters. As well as forming a clear framework to work within, these policies and procedures can assist clients of FoHF ManCos and regulators in understanding how the portfolio manager builds and operates its FoHFs platform.



Once an underlying hedge fund has been selected for investment, a FoHF ManCo should be expected to prepare and maintain information and data in respect of:

- a. the underlying hedge fund’s portfolio construction process;
- b. the underlying hedge fund’s portfolio governance arrangements
- c. the rationale and philosophy behind investment decisions;
- d. correspondence, calls, meetings and on-site monitoring visits with the underlying hedge fund manager;
- e. information on asset allocation and weighting of underlying hedge funds in different portfolios; and
- f. risk management considerations.

Subsequent to this process, upon investment, it should be expected to observe:

- a. clear segregation of duties between investment and execution;
- b. control over the process of notification of investment decisions to underlying hedge fund managers in order to avoid possible mistakes with custodian banks (see 3.1);
- c. clear lines of communication and authority with regards to subscriptions or redemptions from an underlying hedge fund; and
- d. active consideration of portfolio management components such as bridge financing, leverage and foreign exchange (“FX” hereafter) exposure.

The relationship between the redemption terms of a FoHF’s liquidity and the liquidity of the underlying hedge funds holdings should be monitored and appropriately managed.

2.2 Portfolio Construction and Capacity Management

FoHF ManCos usually work with a number of separate portfolios, at any one time, and these portfolios can differ from each other by having diverse objectives, terms, compensation structures and cash flows. FoHF ManCos may sometimes receive preferred terms from the underlying hedge funds such as fees, hurdle rates, preferred liquidity and reserved capacity. In order to reflect these differences accurately and fairly across the portfolios, during the portfolio construction stage of the investment process it is essential that appropriate and repeatable processes and procedures are in place.

There are no prescribed industry standards for portfolio construction however, a distinct process should be created within the overall investment process to accommodate this element. The portfolio construction process should be explainable, with all procedures and processes documented and reviewed periodically. This should assist the FoHF ManCo in ensuring that portfolios are managed to the objectives set out in the offering document and within the constraints of any regulatory body.

2.2.1 Transparency

A FoHF ManCo should implement an investment process with appropriate elements of transparency and decision tracking in order to support the portfolio construction process. Transparency with regards to portfolio objectives and constraints and the components of any investment process should be maintained by a FoHF ManCo and the rationale and philosophy for decision making, including exceptions, should be documented. As outlined in the introduction to this chapter, transparency is important both in ensuring that the staff involved in the investment process clearly understand what is happening and the relevant investor relations personnel can explain this to clients and potential candidates for investment.



2.2.2 Portfolio Objectives

Only underlying hedge funds which have passed the due diligence process may be invested in and policies should be implemented to safeguard adherence to portfolio objectives. Such objectives should include:

- a. diversification rules (i.e., by fund, by strategy, by geographical exposure etc.);
- b. leverage level and currency exposure policy (if any);
- c. investor redemption terms and any potential liquidity mismatch;
- d. other portfolio concentration rules (if any); and
- e. appropriate allocation in-line with the investment restrictions.

2.2.3 Equitable Treatment for Investors

FoHF ManCos should provide equitable treatment for all their investors which will provide a level of comfort for investors and protect the FoHF ManCos from complaints surrounding unfair treatment. In order to achieve this, the FoHF ManCo should ensure:

- a. any conflict of interest is analysed and appropriately managed (e.g., allocations);
- b. fair allocation of any limited capacity obtained from hedge funds managers is undertaken (see 2.2.4);
- c. fair pricing when positions are transferred between fund/accounts is undertaken;
- d. any rebalancing rules are implemented (frequency, limits, minimum transaction);
- e. rebalancing process and frequency is documented; and
- f. any restructurings, side pocketings, payments in kind and redemptions are conducted to reflect the interests of remaining and departing investors.

2.2.4 Capacity and Fair Fund Allocation

It is not uncommon for a FoHF to negotiate capacity with certain of its underlying hedge fund managers. The FoHF ManCo should establish a capacity allocation policy that lays out a set of principles that portfolio managers will follow when determining how to allocate hedge fund capacity among similar accounts that it manages. In the event that the portfolio manager deems it appropriate to allocate capacity differently, the reasons for this should be clearly documented.

From time to time, portfolio managers may find that there is limited capacity in the underlying hedge funds in which they invest. Ensuring that limited hedge fund capacity is equally distributed among clients with the same investment mandate is important. Where the FoHF ManCo operates one commingled or pooled fund, this is achieved automatically as each client has an equal percentage allocation to the underlying hedge fund. Where multiple portfolios exist for which a particular underlying hedge fund is a suitable investment, then fair allocation is a key consideration that needs to be appropriately managed.

Best practice would be to allocate to underlying hedge funds equitably, considering the investment objectives (level of expected risk and return) of each portfolio. It is a requirement to recognise and appropriately balance the interests of all clients in this process.



2.2.5 Responsibilities

Research and portfolio management functions should be separated and the degree of separation will depend on the size of the firm. This will serve to provide checks and balances in the hedge fund selection process. Larger institutions will often implement committee structures e.g., an investment management committee, risk committee etc., which will facilitate a separation of duties, as well as formalise the decision making process. However, despite creating a segregation of duties, a constant dialogue and mutual understanding of roles should exist between the personnel carrying out these functions.

2.3 Dealing and Execution

Dealing by FoHFs in underlying hedge funds is often completed manually and can be a complex process for the following reasons:

- a. underlying hedge funds subscription and redemption terms are not standard (notice to send documents and/or cash may be different between the underlying hedge funds in a portfolio);
- b. side letters may exist to override standard terms;
- c. differences between preliminary net asset value (“NAV” hereafter) and final NAV, which often involve time lags in the allotment of shares;
- d. underlying hedge funds subscriptions may be subject to specific criteria (equalisation factor, shares series);
- e. redemptions may be subject to some specific terms which must be managed (e.g., gates, lock-ups, restructurings, penalty fees, distribution in kind, distribution in two payments, etc.), even for the same underlying hedge funds (different classes) and periodic unadvised cash flows;
- f. there is no clearing house; dealing is usually done through a custodian although, in the absence of a custodian (where the jurisdiction does not require one), may be handled through administrators;
- g. due to the infrequency of redemption and lengthy notice periods, a failure by a service provider to process a subscription or a redemption in accordance with the required deadlines for these events may give rise to a substantial risk of loss before it can be rectified;
- h. due to the frequent manual treatment of subscriptions and redemptions in underlying hedge funds, the complexity and amount of work can be extremely variable; and
- i. several different participants may be involved at this stage of the investment process so clear lines of communication should be established.



Due to the level of complexity of the dealing and execution function, it is essential to have appropriate service providers as well as a strong operations team in place at the FoHF level in order to manage the process. Within the FoHF ManCo, there should be an element of separation of duties between the investment team making the investment decisions and the operations team implementing them. All dealing and execution procedures at the FoHF ManCo should be documented and details of the underlying hedge funds dealing and execution procedures should be kept on file. A well defined and robust process could mitigate the risk of operating losses for the FoHF ManCo.

2.4 Financing, Leverage and FX Risk and Hedging

Both FoHFs and their underlying hedge funds can (although not always) utilise financing, leverage and currency hedging, however this chapter will concentrate on matters associated with FoHFs. Due to some of the complexities involved in using these tools, active consideration, management and monitoring should be carried out. This should assist the FoHFs in avoiding losses caused by operational errors (see appendix 2).

2.4.1 Cash Investment

The selection of the appropriate investment support for cash balances requires the same level of due diligence and analysis as for any other investment made by the FoHF and, indeed, all counterparty risk exposure should be measured by the FoHF ManCo. The basic requirement is to achieve a low risk investment whose liquidity is unquestionable. Certainly, some events have highlighted the need to discriminate carefully among funds or vehicles, which in the absence of proper due diligence, can be viewed mistakenly as safe and secure. The investment of cash balances must be consistent with the investment strategy of the FoHF as well as with planned subscriptions, investments, redemptions and divestments.

If cash is held as an investment in its own right (perhaps due to a lack of investment opportunities) and starts to form a significant percentage of the NAV, then resources such as the use of ring-fenced cash management vehicles should be considered.

2.5 Investment Risk Management

Hedge Funds, like many other investments, can occasionally suffer large losses, therefore risk management with ongoing due diligence and portfolio monitoring, is an important part of the investment process. There are many different hedge fund strategies, with different inherent risks and characteristics. The role of the FoHF ManCo, when selecting underlying hedge funds and constructing a portfolio, is to understand those different risks and then to manage them.

This can be a challenge as hedge fund features such as variable redemption terms and uneven distribution of returns can render traditional investment risk management tools largely obsolete. Also, underlying hedge funds risk reporting and assessment are largely inconsistent, even within the same strategy, and different levels of hedge fund portfolio transparency do not necessarily assist with establishing consistent risk measures across strategies or portfolios. It is therefore essential that risk measures and controls are in place at the FoHF level to capture these anomalies.



2.5.1 Documented Processes

A FoHF ManCo should have a process document for each underlying hedge fund, covering elements of the investment risk involved, both at the time of the initial selection of the hedge fund and during ongoing monitoring, in order to identify, evaluate and manage underlying hedge funds investment risks. This will enable a FoHF to avoid excessive risk and to monitor style drift.

Similarly, a FoHF ManCo should employ a process where elements of the investment risk at the portfolio level are identified and documented (such as concentration and risks limits, liquidity monitoring and escalation procedure). These processes will facilitate the disclosure of risk management capabilities and procedures to the FoHF's investors.

2.5.2 Transparency From Underlying Hedge Fund Managers

In order to carry out satisfactory risk management on underlying hedge funds, the FoHF ManCo will need to obtain a level of transparency from its hedge fund managers. Transparency can encompass disclosure of positions in a hedge fund; access to proprietary investment tools; types of clients invested and investment commitment of the senior management team, to name but a few. The adequacy of this transparency should be re-evaluated at the investment stage and on an ongoing basis, as transparency levels may change over time. A separate account with a hedge fund will provide significantly enhanced levels of transparency for the FoHF ManCo, who should ensure that this information is used properly.

2.5.3 Risk Personnel

Appropriate dedicated risk personnel should be in place to evaluate investment risks, both qualitatively and quantitatively, at the time of investment and during periodic reviews. This will provide an element of independent decision support and insight to the hedge fund selection process of the FoHF ManCo, and will assist with the ongoing monitoring of both an underlying hedge fund manager's investment performance and consistency with the FoHF portfolio's constraints. The activity may be performed by quantitative specialists to provide adequate decision support to the investment process. In some situations, FoHF ManCos will employ external risk management companies to assist with the process.

2.6 Liquidity Management

Best practice should be to match the FoHF's liquidity with the liquidity of the underlying hedge funds. Hedge funds, by nature, tend to take a long time to invest in and redeem from, which can cause a mismatch between the liquidity requirements of the FoHF and its investors. Liquidity management aims to provide a balance.

Over recent years, hedge funds have been demanding and receiving longer notice periods for the redemption of investments made with them and, additionally, redemption dates have widely become less frequent. The imposition of gates, lock-ups, restructurings and side pockets has also become much more common. Many commingled FoHFs may offer redemption terms which are better than the stated liquidity of their underlying hedge fund portfolios.



The *force majeure* clause embedded in almost all FoHFs’ offering documents allows it to suspend redemptions or, sometimes, to redeem in kind. Less liquid redemption terms permit a hedge fund to invest in less liquid instruments or with a longer investment horizon. Less liquid investment, however, does not permit active management and active liquidity management is consequently essential to successfully manage investment risk in a FoHF.

2.6.1 Liquidity Terms

FoHF ManCos should have documented internal policies governing liquidity management of their portfolios. They should incorporate the liquidity terms of the underlying hedge funds into their overall investment portfolio construction and portfolio management processes. These policies and processes should be consistent with the FoHF’s constitutive documents.

2.6.2 Liquidity Management Process

The best practice at a FoHF ManCo is to ensure that the portfolio construction process reflects a reasonable balancing of the following factors:

- a. liquidity actually available from the portfolio of hedge funds (including possible gates, lock-ups, restructurings or side pockets) as well as any preferential liquidity terms;
- b. implications of cash flow from any FX hedging activities, taking into account available banking facilities;
- c. consideration of known liquidity restrictions (gates, lock-ups, restructurings, side pockets and liquidations) of underlying hedge funds;
- d. actual liquidity of the assets in an underlying hedge fund; and
- e. consideration of any other factors such as availability of “emergency” clauses, including, but not limited to, the potential for the suspension of the investors’ redemption rights, in kind distribution and extended lock-up periods.

2.6.3 Transparency on Liquidity Profiles

In managing a FoHF, the FoHF ManCo should ensure that its shareholders and investors have a clear understanding of the liquidity profile of their investments. In order to accomplish this, FoHF ManCos should be able to provide clear and understandable/standardised liquidity measurements of their portfolios taking into account gates, lock-ups, restructurings and side pockets. This should assist both investors and the FoHFs to achieve the most efficient match of assets and liabilities whilst taking into account both the risk profile of the portfolio and an analysis of the investor base of the FoHFs. Some measure of liquidity profile reporting by FoHFs permits a clearer assessment by investors of comparable performance between FoHFs when adjusting for liquidity and should permit investors to make informed redemption decisions.



3. Administration and Operations

This chapter identifies sound practices for the administration and operations of FoHFs. As managers often operate SIPs as well as FoHFs, the processes and controls for both should be consistent.

As outlined in 1.3.2, FoHF ManCos will benefit from proper segregation of duties, by dovetailing major responsibilities across a number of distinct groups, effectively establishing a system of checks and balances within the FoHF ManCo. Internally, there should be an appropriate segregation of duties between investment teams and the risk management/operational staff; and procedures should be established to ensure that third party service providers are acting in the best interests of the FoHFs.

The appointment and governance of service providers by the governing body establishes a high level internal control framework for FoHF ManCos and their investment offerings. The use of an independent administrator offers both investors and the FoHF ManCos many benefits and these are outlined in this chapter which will also cover trade processing and settlement, cash management and control, pricing of portfolios, net asset valuations, maintenance of appropriate information systems and service provider oversight.

3.1 Trade Processing

The FoHF ManCo should ensure that the administrator has adequate internal controls to properly identify and record detailed information on all transactions between investors and the FoHF. Although a FoHF ManCo does not control the FoHF's official books and records, it should develop a process to ensure that any data it receives from investors is sent to the administrator promptly. In addition, the FoHF ManCo should encourage investors to communicate directly with the administrator/custodian bank with respect to their respective transactions in a FoHF. It should be noted that this is not a replacement for good investor relations and client service practices within a FoHF ManCo. Staff involved in those functions should have a full and in-depth understanding of transaction processes so that they can assist investors in this.

3.1.1 Subscriptions

Procedures for dealing with the notification and receipt of subscriptions should be established. The timing of subscription notices and receipt of cash is a key part of managing a FoHF in order to ensure the portfolio manager has enough time to determine the allocation to new funds and that monies are cleared with ample time to invest in underlying hedge funds. FX hedging may also be impacted. A FoHF ManCo should ensure that the planned and actual cash movements are available on a timely basis to the portfolio manager. Measures to reconcile and resolve differences between planned and actual cash movements should also be in place. New investments in a FoHF require the investor to complete and submit an account opening document (subscription agreement). The administrator should perform a proper document review that includes appropriate know your investor ("KYI" hereafter) (also known as "CDD" Customer Due Diligence) procedures to ensure that the documents are complete and to verify the legitimacy and suitability of each investor. The FoHF ManCo should ensure that the FoHF's lawyer reviews a subscription document template for the FoHF ManCo that contains the appropriate representations from the investor including those relating to accreditation and suitability.



3.1.2 Redemptions

Similar to subscriptions, procedures for dealing with the notification and receipt of redemptions are critical in order to submit redemption notices to underlying hedge funds and reallocate investments across each of the strategies in a FoHF. The FoHF ManCo needs to ensure that the planned and actual cash movements are available on a timely basis to the portfolio manager. Measures to reconcile and resolve differences between planned and actual cash movements should also be in place. Each redemption request from the FoHF's investor should be reviewed against the FoHF's offering document; exceptions need to be identified by the administrator, agreed upon by the portfolio manager and approved by the FoHF's governing body. Procedures should be in place to ensure that money is returned to the original account that it was subscribed from.

Liquidation of underlying hedge fund positions can take time and those hedge fund managers may return investors' money in tranches, may gate or hold back some investors. A FoHF must ensure that each of its investors is allocated cash from liquidating investments in proportion to their underlying exposure, at the same time as other investors in the FoHF.

3.1.3 Underlying Hedge Fund Investments

Managers should have adequate systems in place to store and maintain information pertaining to its underlying hedge fund investments. Such information should include liquidity terms; key subscription and redemption dates; dealing and execution procedures; and contact and document management. Much of this can be gleaned from the respective hedge funds offering documents. Submission of subscription forms, monies and redemption notices to underlying hedge funds should be actively managed to ensure that their delivery meets the timing requirements of the hedge fund.

Particular attention must be given to the following points in order to control risk:

- a. all trade tickets must be sent to the custodian or administrator for execution within their specified deadlines;
- b. workflow for sending trades must be prepared in advance with the custodian or administrator. They are usually delivered in a standard agreed template;
- c. trade tickets that are incomplete or incorrectly filled out are usually returned to portfolio managers for the missing data to be completed leading to delays in execution;
- d. portfolio managers must ensure that trade tickets are signed in accordance with their most up-to-date signatory procedures. In the case of electronic transmission, they must ensure internal approvals likewise;
- e. implementing sequential numbered trade tickets is a matter of best practice followed by many FoHF ManCos and custodians/administrators. This enables both parties to control trade ticket flows;
- f. FoHF ManCos must ensure that the custodian/administrator not only possesses the correct document for execution, but also all the requisite information to complete the document; and
- g. procedures must include clear confirmation rules that all trades have been executed.



3.1.4 Trade Errors

FoHF ManCos should have in place policies and procedures to identify and address trade and other errors. An incident report should be written then reviewed by senior management to minimise the likelihood of similar occurrences. Senior management will then decide on an appropriate resolution (e.g., compensation, the guidance to which should be outlined in the policies and procedures).

3.2 NAV Calculation

3.2.1 NAV Calculation Process

The calculation procedures will typically be undertaken by the administrator who will calculate and report on a FoHF's NAV. The policy and methodology for the calculation of performance, management and administration fees should be described in the offering document. The FoHF ManCo should ensure that the administrator has the capability to fulfil calculation requirements comprehensively, including complex fee structures, and that their systems are capable of recording all transactions and calculations.

The NAV of the FoHF should reflect the current fair value of a portfolio of underlying funds or investments. Investments should be valued as of each FoHF's NAV date and/or when investors subscribe or redeem, otherwise referred to as a dealing day. At each valuation date, investments in which the FoHF invests should be valued in accordance with the underlying fund's offering document and/or other fund constitutive documents.

NAVs for FoHFs are reliant on the values received from the underlying hedge funds. A FoHF's offering document should include appropriate disclosures stating that the fund relies on such values in computing its NAV. The NAV of the underlying hedge funds is the starting point for the calculation of the FoHF's own NAV.

The FoHF ManCo should have procedures and systems (independent of the administrator) in place to check all fee calculations and to enable it to include realistic fee accruals into any intra-month NAV reporting to investors. As these will impact the FoHF's NAV, the governing body will be responsible for ensuring that there are sufficient controls in place to independently verify these calculations. Additionally, double checks of the administrator's NAV calculations should be conducted by the FoHF ManCo.

A FoHF's administrator, and/or FoHF ManCo, should ensure that the audited semi-annual (where applicable) and annual reports of the underlying hedge fund investments are received on time and that the NAV per the audited report agrees to the valuation used in the applicable NAV. Any discrepancies should be investigated and resolved immediately.

3.2.2 Other Income

Controls must also be in place to govern the collection of fund income. Key controls may include a reconciliation of amounts received to accrued income and authorisation of fund income accruals, other than dividend or coupon receipts.



3.2.3 Performance Reporting

Appropriate FoHF performance reporting includes annual accounts, as well as monthly or quarterly statements and periodic newsletters. Generally, the timing requirements of a FoHF are stated in its offering document.

3.2.4 Borrowing

The offering document of the FoHF should describe any borrowing facilities that it expects to use including the applicable circumstances under which the facilities may be utilised and any limits on borrowing. A FoHF may borrow for various purposes including bridging the fund's short-term cash flow needs that result from timing differences from planned redemptions to the actual receipt of funds versus the timing requirements to invest in hedge funds (bridge financing). The FoHF ManCo must adhere to the stated terms and develop appropriate borrowing policies and procedures to comply with such terms.

The FoHF ManCo will typically negotiate the borrowing facility terms on behalf of the FoHF and this function is usually delegated to the FoHF ManCo by the governing body. The FoHF ManCo should ensure that contractual and financial constraints involving borrowing facilities are monitored and complied with and that they are fully aware of how the financing counterparty interprets the agreements in practice, and how they value any collateral held against such loans.

3.2.5 Payment of Expenses

FoHF ManCos should maintain proper controls over the payment of FoHF's expenses, ensuring adequate allocations for these periodic disbursements. Instructions to pay expenses should be delivered to the FoHF's administrator on a timely basis to avoid any late charges or interest expense. Likewise, the administrator should provide invoices to the FoHF ManCo on a timely basis so that appropriate reviews and approvals can be completed. The FoHF ManCo should perform analysis of recurring expenses to check that they are reasonable.

Investors expect the administrator to act as an independent check for the proper accrual of non-transaction related expenses such as audit fees, directors' fees and expenses, legal fees or any other significant costs.

3.2.6 Cash Management

The administrator will typically operate a bank account in the name of the FoHF which is used for the receipt of subscriptions and payment of redemptions to investors. The FoHF ManCo should obtain records of net subscriptions and redemptions provided by the administrator. This will enable the FoHF ManCo to monitor and manage its cash flow requirements. In actual or anticipated periods when the FoHF may face any issues in raising cash to match future liabilities (suspension of redemptions from an underlying hedge fund, liquidation of an underlying hedge fund or activation of a gate), the FoHF ManCo should discuss alternative solutions with the FoHF's governing body. This should ensure a fair treatment of the investors, both exiting and remaining, by using the options (i.e., gates, restructurings, suspension of redemptions) as described in the offering document of the FoHF.



3.2 Reconciliation Procedures

Reconciliation is a critical component of the control framework. FoHFs should have controls in place to coordinate regular reconciliations of various accounts between the administrator/custodian bank and the FoHFs, and clear escalation procedures in order to identify and resolve reconciliation differences promptly.

The FoHF ManCo should ensure that holdings used in a FoHF are consistent with the underlying records maintained by the administrator/custodian and the FoHF ManCo itself.

The FoHF ManCo should routinely reconcile each trade instruction delivered to the FoHF's administrator/custodian bank to ensure that all expected activity was completed in accordance with the portfolio manager's instructions. Reconciliations should be performed by staff independent of the investment management function (i.e., middle office) and such reconciliations should be subject to review procedures that ensure that any reconciling items identified are reconciled promptly.

3.4 Valuation

3.4.1 Policy

There should be clearly documented policies and procedures (valuation policy document) in place for valuing the underlying positions within a FoHF and for calculating the FoHF's NAV. The governing body has ultimate responsibility for the valuation but generally delegates the activity to a combination of the FoHF's administrator and FoHF ManCo. The governing body should create and sign off the valuation policy document, which should be strictly adhered to.

A FoHF ManCo should assess the quality of the valuation processes undertaken by each administrator to each underlying hedge fund investment. This will involve appropriate due diligence e.g., reviewing the hedge fund's valuation and pricing policy, determining the appropriateness of escalation procedures for hard to value or exotic instruments and assessing the quality of independent valuation service providers, etc.

The valuation policy document should contain enough detail to avoid ambiguous interpretation, particularly in periods of high volatility, where the integrity of price quotes may become a challenge. The valuation policy document should be made available to investors on request and any changes to the document should be appropriately approved and communicated.

3.4.2 Relevant Regulatory, Industry and Accounting Standards

There is no specific guidance on valuation standards for FoHFs. However, valuation guidance for single strategy hedge funds has been published by AIMA - *AIMA's Guide to Sound Practices for Hedge Fund Valuations (March 2007)* - and many of the principles would apply to the valuation processes for a FoHF. The guide referred to a valuation service provider which, in the case of a FoHF, would be the administrator.

The guide made 15 overall recommendations, and 10 of those are relevant to FoHFs.



Recommendations on Governance

- a. In advance of the FoHF's launch a summary of practical, workable pricing valuation practices, procedures and controls should be enshrined in a valuation policy document and approved by the FoHF's governing body, after consultation with relevant stakeholders. The valuation policy document should be reviewed on a regular basis by the governing body.
- b. The valuation policy document should explicitly clarify the role of each party in the valuation process, should identify price sources for each underlying hedge fund and should include a practical escalation or resolution procedure for the management of exceptions.
- c. The governing body of the FoHF should ensure adequate segregation of duties in the NAV determination process, which may be achieved by delegating the calculation, determination and production of the NAV to a suitably independent, competent and experienced administrator. If the FoHF ManCo is responsible for determining the NAV, and/or acts as the FoHF's governing body, robust controls over conflicts of interests should be established.
- d. Oversight of the entire valuation process and, in particular, resolution of pricing issues with hard-to-price illiquid underlying hedge funds, or where it is felt that an underlying hedge fund value cannot be relied upon or is not available, remains the ultimate responsibility of the FoHF's governing body.

Recommendations on Transparency

- e. The FoHF's offering document should explicitly name the party to whom responsibility for the calculation, determination and production of the NAV has been delegated.
- f. NAV reports should be addressed directly to investors by the administrator. Any NAVs produced by the FoHF ManCo should be qualified as such.

Recommendations on Procedures, Processes

- g. The procedures enshrined in the FoHF's valuation policy document should be designed to ensure that the parties controlling the FoHF's valuation process are segregated from the parties involved in its investment process.
- h. Procedures described in the valuation policy document of the FoHF must be capable of practical implementation by the administrator.
- i. The administrator should use reasonable endeavours to apply any pricing policy consistently. Deviations from the policy should be approved by the governing body in advance of any NAV being released.

Recommendations on Sources, Models and Methodology

- j. Any decision to invest in hedge funds that have side pocketing of illiquid/hard-to-value positions, or to allow the side pocketing of illiquid/hard-to-value hedge funds at the FoHF level, should be taken only after careful consideration by a FoHF's governing body. If the governing body approves such a decision it should ensure that side pockets policies are clearly communicated to all investors. The criteria for side pocketing should be as consistent as possible.



3.4.3 Price Information and Ascertainment

Prices for individual investments in hedge funds are generally reported by the relevant underlying hedge fund’s administrator and are the hedge fund’s NAV.

Since the prices are calculated by different administrators working to different timetables and in different time zones, it may not be possible to collate all the separate, final prices for the underlying hedge fund investments before the FoHF’s NAV is required to be calculated. The objective would be to collect as many final prices as possible, and exceptions should be addressed in accordance with the valuation policy document.

In these circumstances, it is usual for the governing body of a FoHF to set a minimum limit on the current prices, based on coverage of assets under management, which must be collected before the FoHF’s valuation can be considered complete. A documented process should be submitted to the FoHF’s governing body, which should be encapsulated in the valuation policy document.

Where an underlying hedge fund price is not received for the month being reported on, by the deadline for closing the respective FoHF’s books, it may be necessary for the FoHF to use the last final price and adjust for estimated returns within the period since that last final price (as provided by either the underlying hedge fund’s administrator or the manager). Alternatively, the underlying hedge fund’s administrator may release an estimated price. Note that since not all underlying hedge funds may use an external administrator, the source of hedge fund pricing may be directly from the underlying hedge fund’s manager. The use of estimated prices should be within strict limits imposed by the FoHF’s governing body and these should be clearly set out in the valuation policy document. It should also be noted that when releasing a price, accuracy should always take precedence over timeliness, although there should be an aim to achieve both.

Where unconfirmed or estimated prices are used, a subsequent variance analysis should be performed to compare the unconfirmed or estimated prices with the final prices. This will provide data on the reliability of particular administrators and their release of estimated prices, as well as on the reliability of any forecasting of estimated returns to compute an estimated price.

Internal procedures are required in order to deal with cases where a material error is identified in a historical NAV. There also may be regulatory requirements regarding restating the NAV and compensating investors if the error exceeds a certain threshold. In this instance, the FoHF’s administrator should be responsible for restating the NAV and compensating disadvantaged investors. These thresholds should be established in accordance with any local regulatory requirements and clearly set out in the valuation policy document.

When an underlying hedge fund’s annual audited financial statements are ultimately received, a reconciliation should be performed to compare to the final price reported by the hedge fund’s administrator as of the audit date. Any difference above a previously agreed variance as described in the valuation policy document should be reported to the FoHF’s governing body. Differences can be observed at the underlying hedge fund level or at the FoHF level.



3.4.4 Transparency and Disclosure

Where an underlying hedge fund is using a side pocket and the FoHF has a holding in the side pocket investment, then the administrator should obtain details of the basis of the valuation.

Where an underlying hedge fund applies redemption fees or penalty fees for breaking a lock-up, the circumstances of the application of these fees needs to be clearly understood by the FoHF's administrator.

When a FoHF applies a redemption fee or a penalty fee for the breaking of an advance notice period or lock-up, such a fee should accrue exclusively to the FoHF and not to the FoHF ManCo.

3.5 Managing Service Providers

Service providers' roles, responsibilities and obligations should be clearly documented and their performance periodically reviewed and documented by the FoHF ManCo on behalf of the FoHF's governing body, the latter being ultimately responsible for this. The FoHF's offering documents should clearly disclose its service providers including a description of each service provider's business and role. The FoHF ManCo will typically recommend to the governing body the FoHF's service providers at its inception. The FoHF ManCo should evaluate service providers' capabilities including required service levels and proposed fees. The FoHF's governing body will make the final decision as to whom to select and will then enter into the appropriate contracts with each service provider, separately, on behalf of the FoHF.

Service providers contribute to a FoHF's overall risk profile and this should be continuously monitored by the FoHF ManCo and the governing body. Issues that arise at the service provider level may adversely impact the FoHF.

3.5.1 Administrators

The FoHF ManCo should undertake a due diligence process when recommending an administrator to the governing body. The type of questions that should be considered is set out in *AIMA's Illustrative Questionnaire for Due Diligence of Hedge Fund Administrators*.

The initial due diligence should, at a minimum, include details of the administrator/custodian bank, including:

- a. ownership;
- b. client base;
- c. size;
- d. structure;
- e. key management staff;
- f. turnover of staff;
- g. experience of staff;
- h. expertise with similar products;
- i. processes;
- j. technology capabilities;
- k. services offered; and
- l. fees.



The relationship between a FoHF and its administrator should be set out in a signed contract and, where appropriate, supplemented by an SLA signed by both parties. There should be regular communication and occasional meetings between the FoHF ManCo and the administrator to discuss the delivery of key outputs set out in the contract and/or SLA. These will include regular reconciliation of trades undertaken by the FoHF with the records of the administrator, monitoring and reviewing the NAV calculation and other services such as anti-money laundering procedures.

3.5.2 Custodian Bank and Administrator Relationship

The FoHF ManCo must have separation from its custodian and administrator in order to minimise the risk of fraud. Custody and administration can be performed by the same group as each other due to efficiency; however, what should be ensured is that the custody and administrator functions are performed by different legal entities within the common ownership and that there is an absolute segregation of personnel.

It is not uncommon for an administrator to also serve as the FoHF's custodian and some jurisdictions do not always demand that FoHFs employ custodian services. However, as set out in 2.1.5 in relation to assessing underlying hedge funds, the custody of FoHF's assets should be handled by independent and financially sound entities that are appropriately regulated.

3.5.3 Auditors

The relationship between the FoHF and the auditor is set out in an audit engagement letter. In order to achieve an efficient and timely audit, it is important that there is a timetable with clearly defined responsibilities agreed by the governing body of the FoHF, the administrator, the FoHF ManCo and the auditor.

The governing body should consider and agree with the auditor the annual audit plan; the clearance process for all matters arising from the audit and the extent of direct contact the governing body requires with the auditor. There should exist, always, a clear dialogue and regular meetings between the governing body and the appointed auditors. The former should ensure that the auditor is a member of a recognised professional body and of appropriate standing and reputation and that the audit is carried out on a timely basis.

3.5.4 Lawyers

Lawyers provide assurance to the governing body of the FoHF, investors and regulators that the fund is structured in a proper manner.

Lawyers will be instructed in the set up process to advise on structuring the FoHF, to produce documentation, review service provider agreements and recommend on other issues. FoHF ManCos, as well as the governing body, must ensure that the lawyers appointed have the appropriate experience, knowledge and expertise to undertake their assigned tasks, in their respective jurisdictions.

3.5.5 Other

The FoHF ManCo may delegate to external service providers certain other business operations. In all cases, the governing body should undertake sufficient due diligence to ensure that the suppliers have the required level of expertise and experience to carry out the roles to the necessary level. Where appropriate, there should be a formal SLA with clear details of how performance against requirements is to be measured. Regular reviews of service against the SLA should be conducted.



3.6 Operational Risk Management

Operational risk management encompasses many crucial risk factors from an internal and external standpoint. FoHF ManCos should have regular, internal evaluations to determine whether risk factors are being properly addressed and mitigated. Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.

3.6.1 People

FoHF ManCos should engage in the continual recruiting of new talent (where the business can support hiring new employees), and review compensation considerations with respect to current employees. Comprehensive training and proper experience can minimize learning curves and ensure a new hire's immediate value to the FoHF ManCo.

A FoHF ManCo should have detailed key-person loss considerations, outlining a succession in the chain of command for the period immediately following a key-person loss. Further, recruitment for a replacement (of a key-person) from an internal or external source should be tentatively established to minimise the search time for a qualified replacement.

3.6.2 Processes / Controls

These methods should be recorded as the FoHF's operational procedures, which can be updated periodically. Significant changes should be documented, approved and communicated at least to those who have responsibility for executing the control.

3.6.3 Risk Review

FoHF's risk review should involve the establishment of a risk oversight process that would review issues pertaining to key operational processes, including pricing, conflicts of interest, capacity allocation, compliance and other operational aspects of the business. Loss events, including reimbursement and post-mortem situations, are commonly used as mechanisms to mitigate recurrence of the same or similar events. The risk oversight process should be established with clear mandates including the creation and monitoring of key risk indicators ("KRIs" hereafter) which, when triggered, will mandate certain precautionary measures designed to either curtail or prevent negative consequences. Depending on the size of an organisation, it may elect to establish committees to implement and monitor risk reviews.

KRIs should be monitored routinely and should include the analysis of trends. New KRIs should be added as needed and obsolete KRIs should cease to be tracked. Overall risk assessment must be ongoing at all levels throughout the organisation, with suitable processes in place to identify and escalate emerging risks.

Larger firms will commonly prepare and maintain risk matrices that map key operational processes, the types of risks that they present, the probability of occurrence, the average loss amount per occurrence and the key controls that mitigate such risks. This process is generally effective in identifying control gaps and areas for improvement. In order to create the initial mapping, risk assessments should be conducted by the various departments in the firm and reviewed with senior management or their designees, who will critically review the assessments to ensure that they are of a consistent calibre to provide meaningful data.

In addition, capturing and periodically reviewing historical loss events are also beneficial in helping to prevent additional, similar loss events.



3.6.4 Policy Setting

Policy setting protocol should be established and well understood throughout the FoHF ManCo. Senior management, or their designees, should periodically review, revise, and approve the firm's policies. It is essential that written policies and procedures are regularly updated and only include what the FoHF ManCo is actually doing. Regulators routinely cite violations for firms whose written documentation does not match what they are doing in practice. Old versions of policies should be saved in accordance with local regulations and new versions should include effective dates.

3.6.5 Investment Restrictions

Investment restrictions are intended to provide limits on the investment management activities of a FoHF ManCo and, as such, provide investors with an assurance as to the level of risk inherent in the investment strategy. Clients of SIPs may set guidelines which will deal with such matters as the maximum allocation to particular hedge fund strategies, level of investment allowed in any single fund or level of measured risk in the portfolio. Portfolio managers must routinely monitor the adherence to those restrictions and client management and investment systems should be integrated to ensure individual client guidelines are adhered to.

Monitoring by personnel independent of portfolio management is extremely important. This is typically carried out by staff in the middle office or the compliance officer. Exception reporting should be prepared, internally circulated and discussed with portfolio managers on a timely basis.

Clear procedures should be documented to resolve any investment restriction breaches, including communication lines as appropriate. Additionally, adequate consideration of disclosing breaches to the investors and the governing body should be made on a timely basis.

Investment restrictions should be clearly stated in the offering document or in the investment management agreement. Reference to investment restrictions in other marketing materials provided to investors must be consistent with the offering document.

3.7 Information Systems and Business Continuity

3.7.1 Information Systems

There should be high standards of security and integrity over the computer systems that are used by the FoHF ManCo. These are likely to include systems covering areas such as:

- a. order management;
- b. trade capture;
- c. portfolio management;
- d. risk management;
- e. research;
- f. accounting; and
- g. client reporting and information.



The systems used will vary between different firms depending on size, investment strategy and volume of transactions being managed; the FoHF ManCo should determine the most appropriate systems required to manage the business. Systems may be developed in-house or the FoHF ManCo may use external ones. In both cases, the FoHF ManCo should ensure that systems are developed, implemented and maintained in a controlled manner. The existence of the different systems in use and their interaction should be clearly documented.

Inevitably, the operations of a FoHF ManCo will be heavily dependent on the proper functioning of the systems and on the integrity of the information produced by those systems. It is preferable to have automated links between a FoHF and its administrator.

Where the FoHF ManCo places critical reliance on the contents of a spreadsheet, the data should be sufficiently backed up and arrangements should be in place as to who may have access to it.

Systems infrastructure may be located in-house or reputable third party suppliers can be appointed and this may result in differences in control procedures.

Key controls that should be addressed are:

- a. core computer systems should be physically secure to prevent unauthorised access to the data processing area;
- b. the physical area where core computer systems are located should have adequate clean/redundant power, UPS protection, cooling and fire/water suppression systems to ensure best operating infrastructure;
- c. electronic access to the systems should be protected by the use of readily and frequently changed passwords and other arrangements. These systems should be programmed to prevent and detect unauthorised access and any attempted breaches of security should be logged and appropriately followed up. IT security procedures should be regularly reviewed and updated;
- d. a two stage authorisation of input and release should exist on any payment system, promoted by logical access restrictions according to user ID profiles. Passwords on all systems should adhere to adequate standards in length, mixture of characters, frequency of change, last passwords used, etc. A system access request procedure should be in place to document and record the request and processing of a user access change;
- e. network file servers and computers should be protected by virus protection software. This virus protection software must always apply the latest version of the anti-virus file to remain protected against constantly evolving threats. The internal network should be protected by a firewall and perimeter network to protect against unauthorised access from external networks, including the internet. The firewall should be periodically tested to ensure that it provides sufficient protection. There should be clear procedures in place when individuals are allowed to access the firm's systems remotely;
- f. the systems should provide a complete and accurate trail of transactions processed and appropriate procedures should exist for backup, archiving and safe storage retention and retrieval of computer records. This would include daily, weekly and monthly backups of the system and off site storage of backup tapes; and



- g. amendments to systems should be properly authorised, tested and documented. This will enable modifications to the systems to be implemented in a controlled manner. There should be restrictions in place to prevent unauthorised changes and also restrict any changes/upgrades from being made directly in the live environment. Often this process may be delegated to a specialist firm and it is important that it has the requisite skills to modify the systems.

3.7.2 Disaster Recovery

A FoHF ManCo should develop a disaster recovery plan in order to resume operations in the event that its business premises or primary data centre(s) are materially damaged or destroyed. The plan should be documented and periodically tested.

The testing should focus on restoring files and the processing environment to enable pre-identified users to carry on mission critical functions. Periodic testing should be utilised to evaluate the firm's level of preparedness. Conducting a test in which designated staff go to a designated remote location and attempt to recreate routine tasks using the firm's systems/files should be done periodically. The pre-selected site should be appropriate to the size and complexity of a FoHF ManCo.

Testing results should be analysed promptly and corrective measures should be implemented. In addition, senior management should be kept apprised, on a regular basis, of the status of the disaster recovery plan as well as testing results.

Staff should be trained appropriately on the disaster recovery plan. Training may include the reviewing/updating of written materials as well as conducting simulations to create potential working environments that may arise. Copies of disaster recovery materials, once created, should also be maintained by staff at their personal residences for easy access in the event that they need to be implemented. For a more detailed view of disaster recovery, see *AIMA's Guide to Business Continuity Management for Hedge Fund Managers (2006)*.

3.7.3 Business Continuity Plan

A FoHF ManCo should develop a business continuity plan in order to resume operations in the event that normal business operations are interrupted. The firm should ensure that the business continuity plan is owned by a senior business manager (i.e., not just technology), that the plan has been written with input from all senior and key personnel across the business and that the most critical business activities have been recognised and appropriate actions identified to maintain operations.

The business continuity plan, including a full system of tests, should be tested, preferably without warning, periodically. In addition, the senior management should also understand and be satisfied that the service providers have sufficient business continuity plans to support the firm in the event of an emergency.

Copies of the business continuity plan should be prepared and given to the staff of the FoHF ManCo for storage off-site. In the event of a disaster, senior management should be prepared to implement the plan. For a more detailed view of business continuity see *AIMA's Guide to Business Continuity Management for Hedge Fund Managers (2006)*.



3.8 Other

3.8.1 Proxy Voting

For FoHFs, proxy voting comes in the form of underlying hedge fund matters rather than the traditional voting that is common with publicly traded securities. Underlying hedge funds will periodically seek investor consent on varying issues including, but not limited to, changes in liquidity terms or fees. These changes should be evaluated by appropriate staff of the FoHF ManCo including portfolio management. Decisions should be documented by the FoHF ManCo and communicated in a timely manner to the administrator who will prepare and submit the relevant paperwork to the underlying hedge fund. In the event that a FoHF does not consent to a change required by the underlying hedge fund then this could cause the FoHF to consider exiting from that hedge fund.

3.8.2 Periodic Reconfirmation of Hedge Fund Wire Instructions

The FoHF ManCo should have a routine process whereby its middle office (or staff independent of portfolio management) contacts the hedge funds to reconfirm wire instructions. Appropriate controls should be used by the FoHF ManCo to control user rights (access and change) surrounding the storage of current hedge fund wire instructions.

3.8.3 Approval and Monitoring of Side Letter Terms

FoHF ManCos should develop a process for monitoring side letters and most favoured nation (“MFN” hereafter) terms to ensure that they comply with their obligation to disclose and that there is consistency internally in their terms of business with clients. Allowing certain clients to have preferential terms without there being any clear business reason or strategy behind it is not best practice.

A system to monitor side letter terms needs to be established and a central record kept of what these are and with whom (see 4.4.4). This system should be overseen not just by the client management personnel but also by the compliance function.



4. Raising Capital and Investor Relations

Raising capital and attracting suitable investors is often one of the key determinants of the success of a FoHF ManCo. Firms will set up their sales, marketing and investor relations efforts in different ways, usually according to size. Despite the fact that these three functions are separate, and in larger firms there may even be different departments representing them, smaller companies may have one person carrying out all three roles, or will delegate some of the functions to external parties. In whichever way this is managed, when promoting their services and marketing the FoHFs, FoHF ManCos need to consider a variety of complex issues which are dealt with in this chapter. Different FoHF ManCos may adopt different methods when managing their client relationships and asset raising activities and, indeed, the approaches to these functions are often subjective. Despite this, there are tenets that should always be maintained which are that FoHF products are not misleadingly solicited and that all clients are treated fairly.

4.1 Reporting

Providing accurate and timely reports is an important aspect of any portfolio manager's fiduciary obligation to its clients. The portfolio manager should accurately collate both quantitative and qualitative information from its underlying hedge fund managers to reflect what has happened in the portfolio and combine this with more general market views and a view of the outlook for the various hedge fund strategies.

4.1.1 Frequency and Type of Reports

The timing of the delivery of reports is dependent upon the FoHF ManCo receiving return information from its underlying hedge fund managers. The change in value of a FoHF's NAV is calculated to derive the performance of the fund which is expressed as a percentage. In order for the underlying hedge funds NAV to be reported to the FoHF's administrator so that they can accurately compute returns in a timely manner, the FoHF's administrator should establish a systematic approach to collecting such data from the underlying hedge fund managers to deadlines that allow for end-user client reports to be delivered when expected. It is best practice that the administrator should receive NAV data directly from the underlying hedge funds administrators. Hedge fund returns are first reported as estimates and are therefore subject to change and revision.

Most hedge funds and FoHFs report their NAVs on a monthly basis. This corresponds with the month-end when funds are usually able to accept new investments and to pay out redemptions. Some also provide weekly performance estimates but it is unusual for a hedge fund to accept money from, or remit to, clients other than at month-end. The monthly reporting cycle is common to the industry and most clients of hedge funds build their expectations around monthly reporting.

Hedge funds report month-end estimated NAVs as soon as is reasonably practicable after month-end, depending on strategy. FoHFs should therefore be able to send out the following regular reports:

- a. monthly estimate of performance to clients by electronic delivery as soon as is practicable;



- b. detailed monthly report by electronic delivery or hard copy around mid-month;
- c. more detailed and analytical quarterly reports when required by clients;
- d. annual review of performance covering the calendar year; and
- e. independent annual FoHF's audit is performed by an external auditor and sent usually within 6 months of the end of the FoHF's financial year.

FoHFs should be able to provide *ad hoc*, interim or special reports to respond to individual client questions or to report exceptional events such as problems with a particular hedge fund, unusual market conditions or changes to regulations.

All reports should be laid out in a clear and consistent format.

4.1.2 Qualitative Information

Monthly and quarterly reports should include a general market and performance review for each of the underlying hedge fund strategies, for both quarter-to-date and year-to-date time periods. Other qualitative information that may be included in monthly or quarterly client reports could be descriptions of new hedge fund managers included in the portfolio and reports or commentaries on special topics such as new investment strategies or general market trends. Where a FoHF is managing a multi-strategy portfolio and using top-down decision making to shift strategy allocations among the different strategies, an explanation of any changes made and the views behind those changes should also be provided.

4.1.3 Quantitative information

Monthly estimates usually show estimated figures on a total assets basis and the estimated net performance of the FoHF for the preceding month, quarter, year-to-date and since inception. *Ad hoc* reports may indicate the value of the investors' investments.

Monthly and quarterly reports may contain further, more detailed information, such as:

- a. NAV, fund value, transparency on leverage at the FoHF level;
- b. percentage net return for prior month, quarter, year, rolling 3 year and longer periods such as, 5, 10 years, since inception;
- c. appropriate comparators and reference data over identical periods; these should, generally, include the FoHF's target return, plus hedge fund index returns and comparisons with traditional bond and equity markets;
- d. risk measures based on volatility, downside deviation, statistical sensitivity to other investment classes;
- e. some investors may require more detailed measures of risk including estimates of relevant, aggregate leverage and exposure to various markets which have been generated using information provided by the underlying managers;



- f. top-down allocation to strategies and any changes made; and
- g. a statement of the risk and return expectations of the portfolio and any client-specific investment guidelines.

4.1.4 Transparency of Disclosure

Many FoHFs now disclose the names of the underlying managers in their reports. However, there may be some sensitivity on the part of the FoHF ManCo in providing this level of transparency. This is because the names of managers selected could be viewed as proprietary information or commercially sensitive, particularly if the FoHF is engaged in finding new or emerging managers that may have limited capacity. In these cases, an analysis of the portfolio by strategy would be acceptable. It is also possible to offer partial transparency showing, for example, the largest five underlying hedge fund positions or listing all the managers by description rather than name. Generally, institutional investors expect full transparency of underlying hedge fund names.

Where underlying hedge fund managers are disclosed, monthly or quarterly reports should show the weight of the manager in the portfolio, its performance over various time periods and its contribution to the performance of the total portfolio. Most institutional level reports would also contain a description of each manager in the portfolio showing the managers' strategy, style and investment edge or characteristics.

As a minimum, reports should break out performance by strategy and show returns over various time periods by strategy and each strategy's contribution to the performance of the portfolio.

Large institutional investors often request customised reporting to a template that they have developed either themselves or with their consultants. FoHF ManCos with institutional clients should be flexible in their reporting to accommodate these anomalies, where possible.

FoHFs can receive considerable amounts of information from the underlying managers (e.g., some may have full position-level transparency). Confidentiality agreements may exist with certain underlying hedge fund managers which could limit the information given to FoHFs' clients. It is important that any confidentiality agreements that exist with underlying hedge fund managers are not breached by providing such information through client reporting.

4.2 Institutional Clients

Institutional and larger clients will expect forms of communication other than written reports. Trustees of pension funds may require the attendance of their portfolio managers at trustee meetings to conduct a review of the FoHF, its performance and the portfolio manager's outlook. In addition, portfolio managers or members of their team should expect to conduct regular telephone up-dates and conference calls with institutional clients.



4.3 Investor Relations

4.3.1 Relationship Management and Coverage

FoHF ManCos, like other investment management firms, should establish a systematic way of communicating with their clients. The method, content and frequency of client reporting will depend on the type of client but all clients should be able to receive certain basic information and to have access to their manager.

The size of the particular client and/or the chosen approach of the manager will dictate the types of people who will act as a contact for the clients. Some FoHF ManCos will have large client relationship teams (also known as investor relations) and may use intermediaries to maintain relationships. Others, with a smaller number of larger institutional clients, may make more use of their investment professionals to maintain client relationships.

4.3.2 New Client Take-On and Anti-Money Laundering and KYI Requirements

Prior to accepting a new client, it is incumbent upon the FoHF ManCo to ensure that it fully understands who the client is and ultimately where investment assets have been sourced. FoHFs and the FoHF ManCo have a legal and ethical obligation to KYI (see the anti-money laundering matrix at www.aima.org).

It is not uncommon for FoHFs to delegate the anti-money laundering process to their administrator. In this situation, the administrator would be relied on to establish who the client is and to ensure that all documentation regarding the client and their suitability as an investor is filed and periodically updated. The delegation of this function does not imply that the FoHF has delegated its responsibility for ensuring that anti-money laundering laws are complied with.

Having established the credentials of a potential client, necessary documents for investment should be provided to them. These would normally include (depending on the structure of the FoHF) offering memorandum, subscription documents and prospectuses.

4.4 Managing Investor Relations

4.4.1 Client Types and Prospects

FoHFs should distinguish between their different client types in order to establish a client relationship structure that recognises the differing needs and priorities of its client base. Broadly speaking, clients are likely to fall into three main categories:

- a. institutional clients (usually pension funds, insurance companies, endowment funds, family offices, sovereign wealth funds and banks);
- b. individual clients (usually high net worth individuals); and
- c. intermediaries (usually private banks, independent financial advisors, consultants or brokers where the underlying clients are individuals but may also be smaller institutions).



Traditionally, the clients of hedge funds and FoHFs have tended to be individuals or foundations and endowments. From the late 1990s, however, institutional investors have become increasingly prominent. In particular, large defined benefit pension schemes in North America and elsewhere have invested in hedge funds as alternatives to traditional assets to help diversify their asset base. Most of these institutional investors have selected FoHFs to manage their allocations to hedge funds. This has, in turn, led to higher demands being made of FoHFs with regard to client service.

In general, institutional investors require the most frequent, personal and detailed reporting. They tend to be the largest investors and will have dedicated personnel responsible for monitoring external manager relationships and for managing risk and asset allocation across the entire institutional portfolio. Investments in FoHFs, generally, only form a small part of an institutional investor's total asset allocation and it is important that portfolio managers understand the context in which their hedge fund investments sit. For example, an institutional investor that has significant long-only investments may want its hedge fund portfolio to have very low exposure to these major markets to assist in its overall diversification. However, individual investors may have different investment aims and be more interested in generating returns than managing overall risk. Ultimately, the investor will need to select an appropriate FoHF portfolio, or work closely with the portfolio manager to structure a customised, separate account.

4.4.2 Communicating Important Information and Shareholder Notifications

Apart from the usual reporting discussed above, there are certain events that will normally require a special client notification. FoHF ManCos have a duty to ensure that such communications are provided in a timely manner to all clients (it may be a requirement in the agreements they have signed with their clients). Special reporting events would include:

- a. change of ownership of the FoHF ManCo;
- b. resignation or indisposition of senior investment professionals;
- c. unexpected or severe negative performance;
- d. large loss in any individual underlying manager; and
- e. major market events such as those of September and October 2008.

4.4.3 Communication Methods

Email is now the accepted and preferred delivery method for client communications by most investment managers and reports are usually attached as PDF files to avoid alterations. Some clients also expect hard copies of reports and fund audits. Some FoHF ManCos are also able to permit clients to visit a password protected area of their website to download reports and other materials. The independent administrators may also be able to provide clients with information.

Institutional clients generally expect to meet their portfolio managers at least once a year but often more frequently and portfolio managers should be prepared to visit institutional clients and present to trustee boards and investment committees. These visits should provide the client with a first hand and detailed understanding of the FoHF. Some institutional clients may also require regular monthly conference calls to discuss the portfolio and outlook. Many FoHF ManCos have hired specialist institutional client relationship professionals to manage these relationships and meet the specific expectations of institutional clients.



Individual and retail clients also need support and information although this may often be managed through intermediaries such as brokers or other distribution channels. It is much more likely that communication with individuals or retail clients will be managed via written materials rather than personal visits or face-to-face meetings, although larger individual clients may require similar levels of service as institutions.

4.4.4 Client Relationship Management Systems

Client relationship management (“CRM” hereafter) systems are useful tools for the FoHFs to keep a record of clients’ and prospects’ contact details; record details of conversations and meetings and maintain records of what materials have been distributed to whom; monitor side letters; assist the marketing team in updating sales pipelines and storing classification of client types which can often be required for compliance purposes.

Some of this information can be extremely sensitive, therefore FoHF ManCos need to monitor who should be permitted access to this information, internally, and whether data protection issues arise over sharing data across different jurisdictions.

4.4.5 Training and Education

FoHF ManCos can provide an important service in training and educating clients in developing a better understanding of the hedge fund industry by keeping clients updated with any new developments or interesting news. Education can also take the form of sharing knowledge on individual hedge funds and, indeed, pension funds trustees have a fiduciary duty to understand the nature of their funds investments.

4.4.6 Working with Intermediaries

In general, there are two types of intermediary that may assist FoHFs to distribute products or services to clients; those that represent clients and those that that represent the FoHF.

FoHFs that want to develop institutional clients need to work with investment consultants as institutional investors often appoint specialist investment consultants to assist them in the asset allocation of their investments and in the selection of external investment managers. These consultants are independent of the investment firms that they recommend and are paid by the investor. A good investment consulting firm will conduct very thorough research on prospective FoHF ManCos and their FoHFs which will usually result in some kind of comparative rating of the firm by the consultant. This process can be time-consuming and the consultant will require the FoHF ManCo to provide them with access to people, records, systems and the investment process.

The second type of distribution entity would be appointed by FoHF ManCos to assist them in attracting clients. Many FoHF ManCos work with organisations such as banks, brokers or financial advisory firms that have access to, and relationships with, a group of individual clients. Typically, the distributor firm will make an assessment of the FoHF and its suitability for their clients before offering it to the clients. The FoHF will rely on the distributor to market to and communicate with the underlying clients. In some instances, these distributors are just introducing the potential clients and the FoHF ManCo continues to communicate with and service those clients. Investments from these clients can be aggregated and fees shared between the distributor and the FoHF.



FoHF ManCos should take care when entering into these relationships that they have performed relevant due diligence on the distributors and should ensure that terms are fair, that communication with underlying clients is clear and that the responsibilities of each party in the distribution agreement are defined.

4.4.7 Website Management

A website is often the first point of contact for a potential investor with a FoHF but as they are publicly accessible they are subject to the advertising rules and other regulations covering investments. For these reasons, they are often only able to offer very limited information but they can provide a useful doorway to the outside world and assist the FoHF ManCo in the provision of accurate contact information and distribution of published articles and research. They can also provide links to other industry websites such as AIMA.

Some FoHF ManCos are developing client areas in their sites which allow clients with a password to access their own records and reports however, concerns about security have limited this development.

4.5 Performance Measurement

It is very important that FoHF ManCos accurately represent the investment performance they have achieved for clients in the past. Performance track records are one of the items that prospective clients will look at before making an investment and for many clients they can be a deciding factor. It should be noted that over reliance on a track record can lead to disappointment so it is important for a client to assess, also, a FoHF's people, process and business, when making a decision.

4.5.1 Fair Representation

There are a number of ways in which performance track records may not accurately reflect the performance that might be achieved going forward. Apart from the general uncertainty about markets, a performance track record for a FoHF may have been created by a different team not currently incumbent at the firm, may have had a different risk profile, could have been invested in different hedge fund strategies to those currently being offered and may have charged different fees. Portfolio managers must note these factors when presenting performance to prospects or clients.

Portfolio managers must not “cherry pick” performance by selecting a fund or account with the best track record. Portfolio managers must disclose methodologies used for calculating performance.

Global Investment Performance Standards (“GIPS” hereafter) are a set of standardised, industry-wide ethical principles that provide investment firms with guidance on how to calculate and report their investment results (see www.gipsstandards.org). There are, arguably, some difficulties for FoHF ManCos adopting the GIPS code in full, but it does provide a clear outline of the issues facing any portfolio manager preparing investment track records and is good guidance on the approach that they should adopt.



The five areas of the GIPS code cover:

- a. data input;
- b. calculation methodology;
- c. composite construction;
- d. disclosures; and
- e. presentation and reporting.

4.5.2 Indices

It is typical for investment track records to be compared with comparative data and indices. These indices ideally represent the return of the asset class assuming no active decision making by a portfolio manager. In traditional investments, for example, a portfolio manager managing a US equity portfolio might use the S&P 500 Market Index as its benchmark.

It is difficult to benchmark hedge funds, in a sense that would be understood from a long only manager's perspective, as there is no market or passive index and hedge funds are themselves active investment strategies that invest across a range of markets.

There are a number of indices in existence which are composed by combining the performance of groups of hedge fund managers or FoHF portfolio managers. Hedge fund indices can represent individual hedge fund strategy returns or multi-strategy returns. There are issues with the composition of these indices as they are dependent on managers voluntarily submitting returns. These indices are likely to be composed of managers which are quite different to the underlying hedge funds in a FoHF's portfolio and some of the indices are simply non-investable. They are also subject to survivorship and other biases which have been well-documented in numerous academic articles.

It is important, therefore, for investors to consider a range of comparative data when looking at the performance of their FoHF portfolio managers and to tailor these to suit the particular style of their mandate or fund.

4.6 Marketing Strategy

Hedge funds are generally regarded as suitable investments for sophisticated or professional investors. Regulations in most domains restrict the distribution of hedge funds and FoHFs to general members of the public. Any marketing program must therefore start with an understanding of the regulatory environment in any target country. Regulations will usually be explicit about who can be solicited; what can be said and written about the investment products being offered; what the portfolio managers' obligations are with regards to providing information on investments; other risks and the structure of the arrangements. Best practice for a FoHF's marketing director is to develop a plan that is integral to the firm's strategic and business plan, ensuring that products and resources are aligned to achieve stated goals. Strategic consideration should be given to the type of clients that the firm wishes to develop, their domicile and what products are best suited to their needs. Research into the size and characteristics of various investor sectors should allow a marketing plan to be properly targeted with resources available for follow-up and post investment support.

4.6.1 Materials

Most investment firms prepare an armoury of standard written materials to assist in the marketing of their firm's products and services. These would usually include:



- a. presentation book providing information on a firm’s personnel, investment process, structure and products;
- b. historic performance sheets;
- c. product sheets;
- d. completed AIMA standard due diligence questionnaire;
- e. copies of white papers or articles written by investment professionals; and
- f. training presentations.

It is important that materials are maintained to reflect up-to-date information and to ensure consistency and accuracy. These materials should be reviewed by the compliance function, regularly, to ensure that the information provided to investors does not contain any material misstatements or omissions and is in keeping with the regulatory requirements of the applicable regulatory regime.

4.6.2 DDQs or RFPs/RFIs

Institutional investors frequently require FoHF ManCos to complete formal proposal documents as part of the process for hiring FoHFs. These documents are almost always in the form of due diligence questionnaires (“DDQs” hereafter) which are also known as requests for proposal (“RFPs” hereafter) or requests for information (“RFIs” hereafter). Typically, the prospective investor will send out a number of these documents and use the responses to evaluate different FoHF managers and select a smaller number to make a final presentation. Completing DDQs can be time-consuming but is vitally important for firms that aim to attract institutional clients. It is best practice to develop an organised process for the generation of responses to questions, including the proofing and checking and filing of information. A DDQ needs to be accurate and truthful and can be used as an effective marketing tool by highlighting a firm’s unique qualities and characteristics. The types of questions that should be considered for inclusion in a DDQ are set out in *AIMA’s Illustrative Questionnaire for Due Diligence of Fund of Hedge Funds Managers*.

4.6.3 Compliance

As mentioned in previous sections, marketing and sales materials, advertisements and client reports are subject to the scrutiny and standards of various regulatory authorities. FoHFs and FoHF ManCos are also obliged to comply with KYI and money laundering regulations which vary by country. It is important that compliance officers are involved in monitoring and checking marketing materials and in the approval of potential investors. Sign-off procedures should be in place before marketing materials are distributed or presented and records of KYI information should be on file either at the FoHF ManCo or at the administrator, if the anti-money laundering function is delegated to them.

4.7 Fee Structures

Management and performance fees are core components of a FoHF’s fee structure. While the industry estimates that institutional FoHFs charge in a range of 0.5% to 1.5% and 0% to 10% per annum combined in management and performance fees, respectively, a FoHF ManCo should also consider the following when designing the fee structure for a FoHF:

- i. strategy capacity;
- ii. minimum investment amount;
- iii. liquidity; and
- iv. performance fee hurdle (if any).



It is not uncommon for a FoHF ManCo to offer multiple share classes within a FoHF that has different fee structures. In instances where a FoHF ManCo also manages single hedge funds where its FoHF has allocations, the FoHF ManCo should avoid the double charging of fees. One way to achieve this is by creating a no fee share class at one of the fund levels.

4.7.1 Management Fee

A FoHF ManCo earns management fees for their professional oversight, due diligence and ongoing monitoring on underlying funds and allocation of assets. Management fees are charged as a percentage of assets under management and are generally accrued monthly, in arrears. Depending on the mandate of the FoHF, management fees for institutions typically range from 0.5% to 1.5% per annum.

Management fees are used to cover the day-to-day operational costs of the FoHF ManCo, including office maintenance, staff remuneration, staff retention and development, travel expenses, service providers' professional fees and IT development etc. FoHF ManCos may also recover a portion of their expenses through an allocation to the FoHF, as described in the offering document.

4.7.2 Performance Fee

The primary objective of a FoHF's portfolio manager is to generate consistent alpha through meticulous management of a portfolio of underlying hedge funds. A FoHF may also offer a unique risk-return profile which is not available from direct hedge funds investments.

Performance fees are charged as a percentage of performance generated by a FoHF during a predefined time period, normally each financial year-end. A FoHF ManCo usually reports its monthly NAV after accrual of performance fees to-date but will only receive its performance fees after the end of the performance period. To ensure that a FoHF does not get compensated on recouped performance where the performance fee was previously charged, a high water mark should be incorporated to the fee structure. Some FoHF may establish a hurdle return rate which it must achieve before it can charge performance fees and hurdle rates should be applied above the high water mark. Should an investor redeem in the middle of a performance period, any accrued performance fee to the date of redemption would be payable upon exit.

Best practice is that full payment of performance fees to a FoHF ManCo should not be finalised before the annual auditors' report is issued.

4.7.3 Fair Calculation of Performance Fees

Since performance fees are generally calculated at the entire share class level rather than individual investor level, a mid-year investor may suffer an overcharge or effectively be subsidised by another on performance fees in any given performance period.

Equalisation refers to an accounting methodology, designed to ensure that performance fees are fairly allocated between each investor in a fund. It serves to eliminate the problem of one investor being penalised to the advantage of another. There are a number of equalisation methodologies a FoHF ManCo can choose from (see appendix 3).



4.7.4 Hurdles

Performance fee hurdles define the level of return that a FoHF must achieve before it may charge an agreed performance fee. It may be a set percentage or be referenced to an index. Common hurdle rates would be LIBOR or T-Bills or an index that reflects the underlying market in which the FoHF is investing. The purpose of the hurdle is to only reward the FoHF for generating returns that are better than the market (alpha) rather than for returns generated simply by movement in the market as a whole. Sometimes a combination of a hurdle rate and a high water mark can be incorporated in the performance fee structure. Where an index is used, care must be taken in calculating performance fees if the hurdle is beaten but the performance remains negative.

4.7.5 Other Charges to the FoHFs

Certain charges and expenses, in addition to management and performance fees, may also be borne by the FoHF. Costs associated with the set-up of the FoHF, including legal, incorporation, registration and license fees will be treated as preliminary expenses. The offering documents should indicate an estimate or maximum amount to this and include an amortisation policy. If the proposed amortisation policy is not in accordance with the FoHF's adopted accounting standards, the governing body should consult with auditors to provide proper justification and disclosure.

On a recurring basis, a FoHFs is also expected to bear the following costs:

- a. administration fees;
- b. custody fees;
- c. legal fees;
- d. auditor fees;
- e. transactions costs on the purchase or sales of underlying hedge funds;
- f. interest costs on borrowing;
- g. FX transaction costs;
- h. annual registration fee;
- i. annual license fee;
- j. directors' fees; and
- k. liability insurance (e.g., directors' insurance).

In an open-ended fund, it would be typical to write off these preliminary expenses in the financial statements to comply with GAAP (Generally Accepted Accounting Principles) and amortise in the NAV for subscription and redemption purposes. A reconciliation note would be included in the financials to reconcile the two different NAVs.

4.7.6 Fee Scales for Size

It is not unusual for FoHF ManCos to offer different share classes within a FoHF, based on the size of investment that different clients will allocate. Fees will be attached to each of the share classes, usually reflecting a lower scale for the larger investments. In some instances where a discount on fees is agreed (e.g., day one investors into a fund), this will usually be documented in a side letter.

Investors should be aware that if a portfolio manager is able to prove his or her skills in a unique investment space, they will be less willing to give away precious capacity for a below market fee structure, unless there is a strategic rationale for doing so.



4.7.7 Fee Rebates

Rebates from the underlying hedge fund managers or third parties are normally rare, but must obviously be rebated to the actual FoHF and not to the FoHF ManCo. A FoHF may rebate a portion of its gross management and/or performance fees in order to compensate third party distributors for marketing its products as well as servicing its investors. Fee discounts to investors, described above, will typically be managed by means of a fee rebate.

The simplest way to rebate fees is by means of cash, where the rebate amount gets transferred to the investor at each predefined time period. Alternatively, a FoHF may offer the investor the option to reinvest the rebate in the FoHF where new shares will be issued at the date of reinvestment.

4.8 Side Letters

Side letters are letters of agreement, usually negotiated between a FoHF ManCo and an investor in respect of an investment in the FoHF. Most frequently, a side letter will be prepared to provide an investor in a commingled or pooled fund with special terms. These special terms may include lower fees for larger clients, special reporting or a commitment to provide additional capacity to the investor in the future. Side letters may also contain provisions where a promise will be made by the FoHF ManCo to pass on any future special terms which may be offered to new investors, to existing investors (MFN clauses).

Side letters are a useful method of managing different types and sizes of clients' needs within one investment vehicle however, FoHF ManCos need to assess carefully the consequences of allowing their use to grow and should consider alternative methods such as establishing separate share classes or fund vehicles for different types of investors.

4.8.1 Disclosure of Side letters

It is incumbent on FoHF ManCos to reveal where these side letters exist or may exist in the future and their respective percentage. In the case of MFN clauses, FoHF ManCos will be obliged to offer the same terms to the holder of the MFN if a new investor is offered better terms. In both cases, the FoHF ManCos must be transparent to the client. Increasingly, regulators are paying attention to side letters and will ask for FoHF ManCos to present evidence that they have complied with and are monitoring their side letter obligations. Side letters are usually prepared for investors within a commingled or pooled fund which has a standard set of terms and conditions. However, for larger clients particularly, a separate account or SIP may be constructed which is run in parallel to the main fund. If the SIP has different terms to the main fund, this creates the same need for disclosure by the FoHF ManCo.

For more information on side letters please refer to *AIMA's Industry Guidance on Side Letters (September 2006)*.

4.9 Structured Products

FoHFs are used frequently, individually or sometimes in a basket, as the underlying or reference asset for structured or derivative products. These products appeal to retail or institutional investors who, for risk management and/or regulatory reasons, would rather invest in a FoHF backed security than in the FoHF itself (see appendix 4).



5. Fund Structures and Governance

Whilst the foregoing chapters have focused largely on sound practices in connection with FoHF ManCos, this chapter summarises various sound practices with respect to FoHFs.

FoHFs take many different forms and structures and vary substantially with respect to type and complexity of investment strategy and underlying hedge funds. Some of the sound practices outlined in this chapter may include items more relevant to some FoHFs than to others.

A number of different considerations need to be taken into account in determining the most appropriate structure for a FoHF. Foremost among these will be the needs and preferences of the anticipated core investors. It cannot be overstated how important it is to identify at the structuring stage who the targeted investors will be in terms of their domicile, taxable status, base currency and appetite for potentially complex fund structures. It will also be necessary to ensure that the structure deals with any adverse tax issues which might arise from the proposed investment strategy as well as balancing any particular tax planning that the FoHF ManCo may desire to put in place for its own benefit. Careful analysis in the initial structuring of a FoHF can help avoid adverse consequences, delay and additional expense at a later stage.

5.1 Fund Structures

5.1.1 Legal Structure

Portfolios of hedge funds can adopt a variety of structures and the nature of the structure has an impact upon its governance. The most basic arrangement is for the FoHF ManCo to have a contractual relationship with a single investor. In such relationships, the investment management agreement is the crucial contractual document.

In most cases, portfolios of hedge funds are structured as a form of collective investment scheme. In limited partnerships, the most common structure for taxable U.S. investors, an affiliate of the manager generally acts as a general partner. In limited company structures, there is usually a governing body (board of directors or trustees) largely independent from the manager.

The table below illustrates the various legal structures:

Vehicle	Key documents	Typical corporate governance mechanism
SIP/private portfolio	Investment management agreement	Direct contractual relationship between manager and investor
Limited partnership/limited liability company	Partnership deed/operating agreement; private placement memorandum	Affiliate of manager usually acts as general partner/managing member
Trust	Trust deed	Trustee
Limited company	Offering memorandum Company memorandum and articles of association	Governing body (predominantly independent board of directors)



Vehicle	Key documents	Typical corporate governance mechanism
Listed limited company (sometimes closed-ended)	Offering memorandum Company memorandum and articles of association Listing particulars	Governing body (predominantly independent board of directors)
Structured products (note)	Note level: Note term sheet/ PPM Fund level: Offering memorandum	Note level: the note issuer Fund level: Governing body (predominantly independent board of directors)
Mutual funds	Offering memorandum	Governing body

In structures where there is no independent governing body, or where the governing body's decisions may be strongly influenced by the FoHF ManCo or structured note issuer, mechanisms to manage conflicts of interest should be established.

5.1.2 Fund Domicile

FoHFs may be established in any jurisdiction that has suitable legal and tax provisions for the formation of the proposed investment vehicle. Traditionally, FoHFs have been established in domiciles where the choice of location has been driven mainly by the neutral tax treatment of funds in these jurisdictions but also by the fact that some jurisdictions may offer sub-optimal investment choice for investors. For example, a FoHF domiciled in Europe may be subject to mandatory rules on the minimum liquidity it offers to its investors. These regulations, while well intentioned, can be restrictive in a number of ways. The choice of a FoHF's domicile may also determine the extent to which it can be distributed internationally. For example, some of the European Member State regulators will only approve funds that are domiciled in an OECD country for sale in their home territory, whether for sale via public offer or private placement.

It is outside the scope of this Guide to provide comments on the specific advantages and disadvantages of the jurisdictions which are receptive to Funds of Hedge Funds but, appendix 5 lists the countries that FoHFs are located in as of the fourth quarter, 2008.

5.1.3 Taxation Considerations

A FoHF should be structured and maintained in order to preserve or improve upon its tax neutrality. Different structures may have different advantages for different investors. There are too many possible permutations to provide anything other than general guidance in this document. Expert legal and tax advice should be taken at the outset to ensure that neither the activities of a FoHF nor its structure of relationships (including its directors, service providers and its manager) prejudice its tax status. Investors should never rely solely on the offering document but should consult with their own legal and tax advisors.

The tax issues that should be considered in establishing and operating a FoHF will depend on the jurisdiction in which it operates and the jurisdictions in which the activities of the FoHF's directors, service providers and its manager are undertaken. The following is a list of potential tax considerations for a FoHF, the FoHF ManCo and the investors. It is not exhaustive and is merely intended to provide a general idea of the issues that may need to be considered.



Consideration should be given to:

- a. types of tax efficient vehicles available in the preferred jurisdiction(s);
- b. direct taxation rates that will apply to a FoHF and to what income, profits or capital they will apply;
- c. requirements for maintaining the tax residence of a FoHF in the chosen jurisdiction;
- d. whether the chosen jurisdiction provides access to double taxation treaties;
- e. rates of transaction taxes or other indirect taxes payable on a FoHF's investment transactions;
- f. withholding tax requirements on dividend or interest payments made by a FoHF or on realisation of an interest in the FoHF;
- g. any taxation requirements for the types of investors to which a FoHF will be marketed e.g., whether a master-feeder structure would increase the marketability of a FoHF; and
- h. tax information requirements of the investors for tax reporting purposes.

The FoHF ManCo should consider:

- a. direct tax rates applying to the FoHF ManCo and to what extent they may apply to income and/or profits;
- b. whether the activities undertaken by the FoHF ManCo on behalf of the FoHF could create a taxable presence outside the FoHF's jurisdiction or residence;
- c. personal tax requirements of the key individuals; and
- d. any indirect tax costs of the FoHF ManCo.

Investors should consider:

- a. taxation rules applying to income arising from investments in a fund/feeder fund and the tax treatment on realisation of the investment, including whether the rules may differ depending on the percentage ownership held in a FoHF;
- b. any anti-avoidance tax legislation applying to the investment in a FoHF, such as tax rules applying to passive income, controlled foreign companies or other tax efficient fund provisions;
- c. any transfer taxes payable on the purchase and sale of investments in a FoHF; and
- d. tax information required from a FoHF in order to meet tax reporting requirements.

A master-feeder structure is sometimes used to deal with specific taxation requirements of the investors.



5.1.4 Listing

FoHFs may be registered on a stock exchange for one or both of the following reasons:

- a. to make them suitable for certain classes of investor who would otherwise be restricted from investing in unlisted securities; and
- b. to facilitate the availability of NAVs for investors.

Traditionally, a listing on a recognised exchange such as the Irish Stock Exchange or the Luxembourg Exchange might grant exposure to FoHFs for investors otherwise unqualified to invest in those products if they were unlisted. A listing may also help the product to meet domestic regulatory requirements. The purpose of the listing is therefore not to provide liquidity, but to facilitate the compliance requirements of certain institutional investors. Although listings on the Irish Stock Exchange are commonplace, actually trading fund shares on the exchange is extremely rare. Finally, some investors may draw an additional level of comfort from the fact that a FoHF is listed. For example, there may be exchange rules about the level of portfolio concentration or the types of securities that can be traded. The exchange may also set standards for the fitness and properness of potential members of the vehicle's governing body.

A FoHF's governing body and FoHF ManCo should take legal advice as to whether the benefits of listing, outlined above, outweigh the following potential disadvantages:

- a. cost and the initial/ongoing administrative requirements of a listing;
- b. potential restrictions on the investment mandate (e.g., some exchanges prohibit direct investment in certain asset classes); and
- c. reporting requirements, especially within the financial statements, which may require the public disclosure of individual portfolio positions.

The great majority of FoHFs are open-ended, with new units issued and existing units cancelled when an investor subscribes or redeems respectively. A recent phenomenon in the FoHF's industry is the listed closed-end fund. The main motivation for these products is:

- a. favourable tax treatment of such vehicles, the shares of which can be taxed on a capital gains tax basis for certain investors;
- b. provides the FoHF ManCo with semi-permanent capital, and therefore can provide stability both for the FoHF's investors and the FoHF ManCo; and
- c. widening of the profile of the investor base may also be achieved though listing a closed-end company on a major exchange.

Because the shares of the FoHF can be traded on a secondary market they should, in theory, provide much better liquidity to investors compared with an open-ended fund with one liquidity point a month or quarter. Conversely, the potential disadvantage of such vehicles (not unique to FoHFs but to all closed-end funds) is that the price of a FoHFs may trade at a discount to the net asset value of the underlying assets, causing a number of potential problems unless the discount is successfully managed.



5.1.5 Multiple Classes, Ring-Fencing and Other Structural Issues

A FoHF may offer different share classes, sometimes for technical reasons, or to provide options for investors to invest in different currencies, and sometimes they will adopt different fees and liquidity terms. In all cases, the structure should be transparent and understandable for investors.

Master-feeder structures, used to accommodate as many different types of investors as possible without giving rise to allocation and rebalancing issues, can be used for FoHFs. However, because trading usually occurs only once a month, they are less common than for single manager hedge funds.

An umbrella fund may be established using a different class of share for each portfolio to be managed under the umbrella. This structure may give rise to concerns about cross liability, where the liabilities of one share class, perhaps excessively leveraged, exceed the assets of the other sub-funds. In many jurisdictions this risk can now be limited by protecting each share class or “cell” and insulating it from the risk of the other cells.

Side pocket share classes, increasingly common in hedge funds, remain comparatively unusual in FoHFs, although they can be approved by governing bodies in order to keep separate any side pocket share classes and/or restructuring investments in the underlying hedge funds.

Measures need to be adopted to ensure that in the event that a large number of redemptions take place in a fund that is partially invested in illiquid assets, then the remaining investors will not be left with highly illiquid investments (see 2.2.3).

5.1.6 Offering Documents and Material Contracts

The governing body of a FoHF should approve, in a formal meeting prior to the commencement of an offer of interests, a final version of its offering document (usually known as an offering memorandum in the U.S. and as a fund prospectus in Europe and Asia). The governing body and its advisors should be satisfied that the offering document properly reflects the underlying constitutional documents of the FoHF (typically the articles of association or limited partnership agreement).

Material contracts between the FoHF and its service providers, which should also be described in the offering document, will typically include:

- a. investment management agreement with the FoHF ManCo; and
- b. administration agreement with the administrator (who will also normally act as registrar and custodian for the FoHF, if the jurisdictions do not require a separate custodian).

5.1.7 Appropriate Professional Advice

In evaluating its organisational structure and ongoing operations, the governing body of a FoHF should take appropriate advice from lawyers, accountants and other advisors. These advisors should be suitably qualified with experience of the jurisdiction and rules applicable to the FoHF.

In practice, a FoHF tends to engage at least two sets of advisors, one based in the jurisdiction of the FoHF itself and the other based in the jurisdiction of the FoHF ManCo to opine on regulatory or other issues which may have an impact upon the FoHF.



5.1.8 Governing Body (or Independent Directors)

The majority of FoHFs are incorporated as companies in tax neutral jurisdictions, where the governing body will tend to be a board of directors. *AIMA's Offshore Alternative Fund Directors' Guide (2008)* contains a large amount of guidance which is relevant for the directors of FoHFs.

The composition of the board of a FoHF's company will usually be influenced by fiscal considerations and by the company law and/or listing rules of the country where the fund is incorporated/listed. As well as these considerations, it is important for the board to be as robust and as independent as possible, preferably with a majority of genuinely non-executive directors (as opposed to directors who are employed by, or have a close relationship with, the FoHF ManCo).

The governing body of a FoHF should be carefully selected with due diligence being conducted on prospective directors, with the focus being on the selection of those with sufficient experience and expertise to perform their duties. The due diligence should be comprehensive including performing on-site visits and hiring business intelligence professionals to conduct a comprehensive review of the respective individuals and companies. The selection of non-executive directors, in which the FoHF ManCo will naturally be involved, requires a balance to be struck between avoiding boiler-plate directors on one side of the spectrum (who will lack sufficient experience and gravitas) and avoiding celebrity directors on the other side of the spectrum (who may not have sufficient time to focus on their duties and may also be a drain on the FoHF's resources). It is appropriate for a majority of the governing body to be independent from the FoHF ManCo or, if applicable, its investment advisor.

Once a board is established, board meetings should be held sufficiently frequently so that the governing body is effectively able to carry out its role and this is ultimately a matter for each governing body to decide in light of its duties. Such frequency should be disclosed in the FoHF's offering document. In addition, the governing body should receive routine communications from the administrator and FoHF ManCo including performance results.

For very large or complex funds, the board may consider the establishment of sub-committees (e.g., for valuation, audit or fair treatment of investors).

The governing body (or the FoHF ManCo on their behalf) should have regular contact with the service providers to establish good relationships, monitor and review information flows, deal with issues as they arise and continue to look for ways that the service providers can add value. There should be clear escalation procedures to cover the raising and resolving of serious failures in the delivery of service to the FoHF by third party providers.

5.2 Corporate Governance

The overriding principle of FoHF corporate governance is that the structures and mechanisms in place should be at least as robust as those which FoHFs expect to see established for the underlying hedge funds in which they invest.

The key aims of the FoHF's corporate governance structure will be:

- a. management of any potential conflicts of interest; and
- b. equitable treatment of investors.



These goals should be achieved by a robust, independent governing body but the precise corporate governance framework will depend, to some extent, on the nature of the FoHF. Whatever the precise nature of the governing body, it should be responsible for:

- a. vetting of any side letters or MFN letters in relation to the FoHF, including an assessment of whether entering the side letter disadvantages remaining investors in the FoHF;
- b. authorisation of any suspension of dealing or imposition of a gate upon the FoHF, ensuring that it is in the interests of all investors, in the aggregate;
- c. authorisation of any waivers of redemption fees, lock-ups, notice periods, minimum subscriptions;
- d. recommendations on fair treatment of investors in situations where the FoHF ManCo or structured note issuer owns founder/special voting shares (e.g., the governing body may recommend that investors should be allowed to exit a FoHF without penalty if its terms are changed by the exercise of founder-share votes); and
- e. reviewing the valuation of any assets or liabilities where the FoHF ManCo has had material input into the process. *AIMA's Guide to Sound Practices for Hedge Fund Valuation (2007)* has more details on the principles behind these issues. For FoHFs, the FoHF ManCo is usually involved on the rare occasions when an underlying hedge fund does not issue a NAV or there are serious doubts as to whether the issued NAV reflects real fair value. Nevertheless, there should be a written valuation policy outlining the procedure when the input of the FoHF ManCo is required.

Conflicts of interest are a particular issue when the FoHF ManCo is effectively also the governing body of the FoHF. Best practice is that the governing body of the FoHF ManCo is separate from the governing body of the FoHF. There must be a clear segregation of duties between those officers managing the company and the majority of those managing the funds. Alternatively, independent service providers can be commissioned to perform governance roles.

5.3 Independent Service Providers

5.3.1 Fund of Hedge Funds Management Company (Manager or Investment Manager)

The role of the FoHF ManCo is to manage the assets of the FoHFs according to the terms of the investment management agreement.

The governing body should review the performance of the FoHFs on a regular basis, if possible, benchmarked against a relevant peer group. The FoHF ManCo will typically report to the governing body on a periodic basis.

The governing body should satisfy itself, on a regular basis, that the FoHF is being managed in compliance with its investment mandate (usually enshrined in the offering documents). The governing body should also review, periodically, the FoHF ManCo's allocation policy for underlying funds where capacity may be limited.



The governing body should satisfy itself, on a regular basis, that the FoHF complies with all regulatory and listing requirements in relation to the management of investments (e.g., portfolio concentration limits) and the management of investors (e.g., ERISA limits). These requirements tend to be more exacting for listed closed-end FoHFs.

The governing body should satisfy itself, on a regular basis, that the day-to-day management of the FoHFs (by the FoHF ManCo and its administrator) is sufficiently robust, with segregation of duties and risk controls where necessary. The governing body should also periodically review the due diligence which the FoHF ManCo performs on the underlying hedge funds own governance, operational and valuation procedures.

5.3.2 Administrator

The roles of the administrator of a FoHF are to provide fund accounting and registrar/shareholder services. Usually, these roles are covered by a single administration agreement, although it is now very common for the administrator to carry out accounting and shareholder services in different locations. In addition, as noted in 3.5.2, it is not uncommon for an administrator to also serve as the FoHF's custodian.

The administrator is often the FoHF's main contact. The administrator's functions are likely to include:

- a. coordinating opening bank accounts for the FoHF, along with the custodian bank;
- b. receiving and processing subscriptions and redemption requests;
- c. valuing the FoHF's underlying investments;
- d. producing and reporting NAV calculations;
- e. reconciliation of the portfolio;
- f. calculating and paying management and performance fees;
- g. acting as company secretary;
- h. preparing annual and interim accounts;
- i. maintaining the shareholder register;
- j. arranging payment of redemption proceeds;
- k. coordinating communication with investors;
- l. implementing anti-money laundering procedures; and
- m. dealing with the accounting complexities of the FoHF's structure, e.g., side pockets.

A very common solution to potential conflicts of interest in fund valuation is for the governing body to delegate to the administrator responsibility for producing the formal NAV of the FoHF on which subscriptions and redemptions are based. If the governing body relies on an administrator for this, it should be satisfied that the administrator is competent and experienced enough to deal with technical issues which might arise, and to flag immediately any more material or suspicious matters.



The governing body is also likely to delegate the anti-money laundering and client due diligence duties to the administrator although, as mentioned in 4.3.2, only the function is delegated whilst the responsibility still remains with the governing body and the FoHF ManCo.

5.3.3 Custodian

The custodian (if required by the jurisdiction) may also perform the role of trustee, reviewing the FoHF's compliance with the investment restrictions outlined in the offering documents. It is therefore normal for the FoHF's administrator to process each allocation decision (interfacing with the administrator of each underlying hedge fund) and to be the custodian of the nominee account in which the FoHF's investments are held.

The custodian's functions are likely to include:

- a. investing and redeeming from hedge funds based on clear instructions;
- b. preparing necessary documentation required by hedge funds (subscription documents, questionnaires and any contract or other documentation required by the administrators of the hedge funds);
- c. maintaining copies of all documentation relating to the FoHF's investments;
- d. holding, for the account of the FoHF, all assets of the FoHF;
- e. releasing and delivering assets owned by the FoHF upon the receipt of proper instructions;
- f. ensuring that investments are registered in the name of the custodian or in the joint name of the custodian and the FoHF;
- g. coordinating opening bank accounts for the FoHF, along with the administrator;
- h. handling FX transactions; and
- i. providing financing.

FoHF's assets held by custodians tend to be segregated against other assets of the custodian. In the event of bankruptcy, an administrator or liquidator would look on these assets as separate to any claim against the custodian. However, cash balances (although to the benefit of the FoHF) are held on the custodian's balance sheet and are not segregated due to operational constraints. A FoHF should be aware of this and manage it accordingly.

It is unusual for FoHFs to engage a prime broker because the FoHF ManCo will not be trading securities on a discretionary basis in secondary markets, but making allocations to individual hedge funds under the terms of each underlying hedge fund's offering document.

5.3.4 Auditors

The role of the auditor is to provide an independent opinion, generally annually, on the financial statements of the FoHF in accordance with the appropriate and relevant auditing standards. Auditors may also report on, or review, interim financial statements. The auditor may be engaged by the FoHF to provide other services including tax advice, reporting and agreeing appropriate valuation procedures and should therefore be sufficiently resourced to handle these matters. The terms of any additional services should be covered by a separately agreed upon engagement letter.



FoHF ManCos must appoint auditors with the appropriate hedge fund expertise to audit the annual accounts of the FoHFs. The FoHF ManCo is likely to retain an auditor to audit its own corporate entities, which may or may not be the same as the auditor of the FoHF; this is a matter of individual preference, as there are no rules or clearly established practices for this situation.

Typically, the administrator is responsible for maintaining the accounting records of the FoHF and the preparation of draft accounts for audit. The FoHF's auditor will work closely with the administrator to complete the audit work; where the administrator operates in a different jurisdiction from the FoHFs, the auditor will need to coordinate audit work performed in one office with audit sign-off in another office (where the law requires local sign-off in the jurisdiction of the fund e.g., Cayman Islands).

There should be a clear process in place so that any issues resulting from the audit can be brought to the attention of the governing body of the FoHF. The governing body of the FoHF should monitor the relationship with the auditor and oversee the annual audit process. The governing body should approve the audited financial statements before they are issued and filed with a regulator, if applicable.

The governing body should be satisfied, sometimes receiving advice from the FoHF ManCo and/or administrator, that the auditor is suitably qualified and experienced. The governing body should also satisfy itself that there are no conflicts of interest which would compromise the auditor's integrity. Auditors themselves are bound by their own regulations and professional standards not to accept other advisory work from the FoHF which might create such conflicts of interest.

The terms of an auditor's appointment are usually enshrined in an audit engagement letter, which the auditor periodically updates. The governing body should formally approve these letters before any audit fieldwork commences. They may seek advice from the FoHF's lawyers as to whether the level of any cap on the auditor's liability, included in the engagement letter, is reasonable.

5.3.5 Lawyers

As noted in 5.1.7, a FoHF ManCo usually engages firms for its FoHFs. The governing body should be satisfied, sometimes receiving advice from the FoHF ManCo, that the lawyers in question are suitably qualified and experienced.

Lawyers will certainly be involved in the preparation of the FoHF's constitutional documents. They will then be called upon by the governing body on an *ad hoc* basis when issues arise. The governing body should be alert to any potential conflicts of interest caused by the FoHF's lawyers advising the FoHF ManCo or investors on other matters.

Appendix 1 Single Investor Portfolios (SIPs)

Larger investors frequently choose to invest in a FoHF where the investment is structured for the sole use of that investor. These investment vehicles, known as SIPs are also referred to as managed, segregated or separate accounts. The important distinction with these arrangements is that the investor is not commingled with other investors in a FoHF but invests in a dedicated portfolio of hedge funds. A SIP is usually only offered to an investor with a larger amount to invest (usually \$50million or more, although the minimum requirement to create a SIP is the business decision of each separate management business).

Structure

SIPs can be structured in a number of ways but usually take the form of either onshore or offshore investment companies with limited liability. SIPs can also take the form of trusts or other types of investment funds depending on the domain. The company, trust or fund's sole purpose would be investing in hedge funds on behalf of the client. The client is normally an institution such as a pension fund, insurance company or endowment fund.

Governance

The SIP is usually governed by a board of directors (if it is a corporate entity) or by trustees. These individuals may be independent of both the client and the FoHF ManCo or could be representatives from either or both parties.

The SIP is advised by the investment manager, in this case the FoHF ManCo, and establishes a management or investment advisory agreement with the FoHF ManCo. The FoHF ManCo is responsible for the selection of hedge funds and for making recommendations for the appointment and removal of underlying hedge fund managers. These responsibilities are usually discretionary, giving the FoHF ManCo the ability to make the investments it deems appropriate. The board of directors or trustees usually has the ability to remove and re-appoint the FoHF ManCo, if necessary.

Advantages of SIPs

There are a number of advantages of SIPs from the point of view of the investor:

- a. investment strategy or guidelines can be tailored to fit the requirements of the investor;
- b. investments are dedicated to that investor; decisions can be taken with the sole interests of the investor in mind and the investor is not subject to the potential negative impact of other investors either entering or leaving a commingled fund;
- c. terms (such as fees, redemption provisions and lock-ups) can be established which reflect the requirements of the investor rather than a group of investors;
- d. an investor can choose the domicile and vehicle structure that best suits its tax and other regulatory needs;
- e. the investor is the sole and ultimate owner of the assets through the SIP rather than sharing in commingled investments; and
- f. the investor can be in the position of changing its FoHF ManCo without having to liquidate investments in a commingled fund.

Disadvantages of SIPs

There are also some disadvantages which need to be considered:

- a. the additional legal and administrative costs involved in establishing and managing SIPs;
- b. an additional administrative burden for the FoHF ManCo in allocating assets to a number of SIPs rather than through a single commingled vehicle;
- c. investing in a commingled vehicle may give a client access to hedge funds that are closed and would not be available for investment by a SIP; and
- d. from time to time there may be advantages to investing in a commingled fund, for example, there may be diversification benefits in subscribing to a fund that contains several investors.

On balance, there may be good reasons for larger investors to choose a SIP structure rather than investing in a pre-existing commingled FoHF. The growth in the use of SIPs can be expected to continue as more and more large institutional investors invest in FoHFs.

Appendix 2 Leverage, Financing and FX Risk and Hedging

Leverage

There are different sources and types of leverage:

- a. a distinction must be made between leverage at the FoHF level (bridge financing, investment leverage, unrealised FX P&L) and leverage at the level of the underlying funds;
- b. a second distinction must be made between leverage in the form of direct financing and leverage incurred through off balance sheet transactions in the form of derivatives. This appendix will concentrate on leverage resulting from bank/prime broker financing; and
- c. leverage will also be considered here as ongoing recourse to financing (primarily with a view to enhance performance), as opposed to the short term use of bank debt for the purpose of financing temporary cash flow mismatches (such as mismatches between subscriptions and investments, redemptions and divestments and realisation of FX losses).

It is important, however, that portfolio managers properly analyse leverage at the consolidated level of each FoHF (i.e., the combined leverage of the underlying hedge funds and of the FoHF) and leverage consisting of both direct finance and derivatives.

FoHF ManCos must address three key and related issues:

- a. the level of leverage that it is prudent to incur in relation to the liquidity of the underlying funds, such liquidity being usually itself a function of the strategy implemented by underlying funds, the liquidity of their own assets and the liquidity terms as decided by the underlying hedge fund manager;
- b. the dependability or revocable nature of the bank financing used; and
- c. pricing/cost of debt.

Different regulations mean that it is not always a requirement that FoHFs disclose their leverage however, disclosure to investors should be encouraged as a matter of good practice.

Financing

As mentioned above, bank financing can be provided through traditional means or through derivative-based structures. In the latter case, a good understanding of the workings of the derivative is required to compare this type of funding to traditional debt. The preference of banking institutions for such “structured” financing is mostly driven by regulatory constraints. It is therefore essential for FoHF ManCos to assess the regulations involved and the potential impact of changes in those regulations on the availability and cost of credit.

Traditional prime broker/bank debt financing can take various forms, either as outright borrowings or repurchase type agreements.

Portfolio managers should give careful consideration to the following characteristics, among others, of the various forms of funding:

- a. tenor must be clearly consistent with the purpose of the financing i.e., investment leverage or short term liquidity; lenders will define the purpose of the funding in the documentation;
- b. financial institutions will typically impose various covenants as well as maximum ceilings for drawings, expressed in the form of an absolute amount or a percentage of the FoHF's assets. It is the responsibility of portfolio managers to assess the sensitivity of these covenants to various scenarios and ensure they are compatible with the risk/return objectives of the FoHFs;

- c. some covenants may be particularly sensitive and have potentially direct consequences such as cross default provisions or mark-to-market triggers which can result in the forced liquidation of assets at inopportune times; and
- d. availability of funding can be reinforced through committed facilities but their cost and need must be evaluated by portfolio managers.

FX Risk and Hedging

Given the volatility of FX markets and the ensuing risk of significant financial losses caused by operational errors, portfolio managers must implement comprehensive controls and rules for all spot and forward FX deals, at the time of deal execution and at regular intervals. These should include at least:

- a. double check before dealing any FX trades (spot or forward);
- b. clear rules or procedures for tolerance for FX hedging adjustments, and forward maturity, taking into consideration any in/out flows;
- c. regular control of the FX exposure; and
- d. fair allocation of the FX P&L.

In view of the intricacies of effective foreign currency hedging, portfolio managers may find it appropriate to resort to outside overlay specialists. However, the FoHF ManCos should still ensure that suitable in-house controls are in place to avoid losses or mistakes.

There are 2 types of FX hedging transactions:

- a. investment hedging: if the currency denomination(s) of the underlying funds is different from the base currency of the FoHF, the resulting risk must be properly hedged; and
- b. class hedging: in case a share class is denominated in a currency that is different from the FoHF's base currency, it must be properly hedged as well; such transactions may justify/require (partial) netting with transactions entered into as a result of the hedging indicated in the above paragraph.

The cost of some share class FX hedging transactions (through options or futures) can be allocated with precision to the share class involved; on the other hand, other types of hedging transactions (e.g., through forward contracts) have an impact on the cash position of the FoHFs as a whole. FoHF ManCos must analyse carefully the impact of these transactions on the NAVs of the different share classes with a view to maintaining equal treatment for all investors. A clear distinction between trades executed for investment hedging and FX class hedging must be identified to ensure a proper allocation of the FX P&L across the classes of shares. The use of a compartment structure rather than share classes obviates this issue.

The offering document of the FoHFs should provide detailed information on the FX risk policy implemented by the manager; in the case of FX losses with a significant adverse impact on the FoHF's performance, the FoHF runs the risk of being made liable if foreign currency hedging is not carried out in accordance with the stated policy.

In all instances, when a FoHF utilises leverage, financing and FX risk, and hedging, and uses a counterparty to facilitate the processes, then that counterparty should undergo thorough due diligence checks by the FoHF ManCo with a strong focus on counterparty risk.

Appendix 3 Series of Shares and Equalisation Methodologies

Series of Shares Method

This requires a FoHF to issue a new series of shares each time there is a subscription. Every month, when calculating the NAV per share, the correct performance fee accruals, if any, are applied to each of the series separately. The first series of shares, which are issued when the FoHF is launched, is usually known as the "lead series". At the end of each performance period, each of the subsequent series that has paid a performance fee will be consolidated into the lead series if the lead series has also paid a performance fee. Series that have not paid a performance fee will remain outstanding until a subsequent period end when a performance fee is payable. If shares are redeemed before the end of the performance period, shares are redeemed on a first in, first out basis.

Equalisation Method

There are various ways in which the equalisation method can be implemented but below are three methods that are commonly used:

- a. **Equalisation Shares:** adjustments are made to each individual's holdings, by issuing a number of equalisation shares each month, when necessary. These adjustments are based on each individual's situation (e.g., high water mark NAV, the NAV at the time the investor purchased the shares, the current NAV, etc.), to ensure that the appropriate amount of incentive fee is paid.
- b. **Equalisation/Depreciation Deposit:** the FoHF calculates a gross asset value ("GAV" hereafter), (i.e., NAV before accrual of performance fee) and a NAV. The difference between the two is equalisation. The high water mark for the FoHF is usually reset annually, at the start of each performance period.

If a shareholder invests during the performance period, they are investing the NAV plus either an equalisation factor or a depreciation deposit. If the FoHF has increased in value during the performance period, the new investor pays the GAV in order to place the same amount of funds that are invested as existing shareholders. If the FoHF retains its performance by the end of the performance period the equalisation paid will be refunded in shares at the end of the year. If it loses value, the equalisation will be lost for that period, but is refundable in the future if the FoHF recovers that value.

If the FoHF has lost value before an interim subscription, a depreciation deposit is charged on the new investment. As the FoHF recovers its losses the depreciation deposit becomes payable to the investment advisor as performance fee.

- c. **Equalisation Adjustment:** This method is similar to the Equalisation Factor/Depreciation Deposit approach, except that no depreciation deposit is collected. Instead, the situation whereby investors are not charged an incentive fee is prevented through a mandatory redemption of a small number of shares at period end, the proceeds of which are paid to the investment advisor based on the gains earned by that particular investor. Under this approach, an investor who subscribes during the performance period always pays the GAV to place the same amount of funds at risk as other investors. At the end of the performance period, a FoHF level incentive fee is calculated based on the FoHF's hurdle rate or its loss carry forward position. After the FoHF level fee is determined each investment is reviewed and a separate investment-level incentive fee is determined based on individual circumstances.

When choosing between methodologies, a FoHF ManCo should factor in any regulatory needs, the comfort level of the FoHF ManCo as well as its familiarity with investors.

To facilitate investors' understanding of the methodology adopted, FoHF ManCos often create a separate section (e.g., an appendix to the offering document) to explain the mechanics of calculation and provide appropriate illustrations.

Appendix 4 Structured Products

FoHF ManCos should make appropriate distinction between the various types of structured products. Although a considerable number of variations exist, three basic types can be distinguished:

- a. certificates, known sometimes as “Delta One” products: these structures do not involve any capital guarantee and are generally unleveraged. They are adaptations of a FoHF or basket of FoHFs into a security issued, typically, by a banking institution. They can appeal to retail investors who may be restricted by local regulations or for tax reasons from investing directly into FoHFs. Delta One products can be developed by a FoHF and a bank for joint marketing purposes; in such cases, the certificate will then be free of charge for investors and the bank is remunerated by rebates from the FoHF;
- b. two types of “note structuring” provide a capital guarantee at maturity and some may involve a degree of leverage.
 - i. CPPI products (“Constant Proportion Portfolio Insurance”) combine investments in the underlying FoHFs with investments in risk free assets, such as money market instruments, with a dynamic rebalancing of the mix depending on the distance between the NAV of the underlying FoHF and the level of the zero coupon (risk free asset); and
 - ii. options-based products combine a zero coupon bond with an option on the underlying FoHF purchased with the initial discount to the par of the bond. The two components are managed in such a way as to create the required pay off profile of the note. There are currently a considerable number of innovative options-based products paying different pay offs at maturity. A problem inherent in these products is that they are based on models, difficult to understand by investors. FoHF ManCos must be aware that they can involve hidden fees and that the amount actually invested in the FoHF can be less than 100% of the product notional which may make the product less attractive for the FoHF ManCo.

These capital guaranteed products can appeal to risk averse investors who seek full capital protection at maturity.

Structured products can be attractive for FoHF’s investors. These products are often tailor-made and address all kinds of investors’ needs in terms of cash flow or risk/return profiles. Nevertheless, it is essential for FoHF ManCos to understand the performance drivers of these structures; their potential impact on the day-to-day management of their FoHFs and the interactions this particular type of investment may have on other investors in the FoHFs. The FoHF ManCo must also have an understanding of the FoHF’s characteristics analysed by a structured product provider and of its selection/exclusion criteria.

Possible Problems

The FoHF ManCo must be aware of the potential pitfalls inherent in the presence of structured products among the FoHF’s investors, among others:

- a. investment management disruptions caused by frequent subscriptions/redemptions resulting from rebalancing requirements in the structured product (especially in the case of CPPI products and in the case of retail oriented products involving a large number of small ticket investors);
- b. associated processing costs caused by high frequency subscription/redemptions patterns;
- c. sudden partial or total deleveraging of the product if the distance between the underlying FoHF’s NAV and the zero coupon gets too small; and
- d. additional reporting and/or covenant monitoring requirements.

Fund of Hedge Fund Management Company's Considerations

The FoHF ManCo must:

- a. have a full understanding of the counterparty risk and perform due diligence when selecting a structurer;
- b. understand who initiated the structured product under consideration: the structurer's initiative or the FoHF ManCo's? This will make a considerable difference to the marketing strategy;
- c. have shared responsibility in terms of investor information regarding the structured product and must ensure that the structurer provides comprehensive and transparent information to investors regarding the underlying FoHFs;
- d. understand all transparency issues regarding the structurer's option pricing model;
- e. manage investors expectations regarding the risk/return attributes of these products.
- f. understand that the level of fee retrocession to the structurer has a major influence on the performance delivered by the product to investors;
- g. understand the mechanism of the structure in order to identify the different levels at which fees are charged by the bank; and
- h. understand that the 'hedging' associated with structured products required increased operational and monitoring expertise.

In summary, structured products can provide attractive responses to various kinds of investor needs such as solving regulatory restrictions or specific cash flow profile requirements. They can also enhance returns through the use of leverage.

Such advantages must however, be carefully assessed by FoHF ManCo against the potential for disruptions in the FoHF's management; the need for transparent investor information; potential image and reputational risks and an excessive dependence on such a source for origination of investors.

Appendix 5 Location of FoHF ManCos

Source: *hedgefund.net*

	As of Q4 2008	
Country	Funds of Funds	% of Total
USA	897	29.2%
United Kingdom	774	25.2%
Switzerland	615	20.0%
France	105	3.4%
Bermuda	81	2.6%
Italy	76	2.5%
Channel Islands	64	2.1%
British Virgin Islands	62	2.0%
Cayman Islands, BWI	56	1.8%
Luxembourg	43	1.4%
Hong Kong	35	1.1%
Bahamas	29	0.9%
Netherlands	20	0.6%
Austria	17	0.6%
Sweden	17	0.6%
United Arab Emirates	16	0.5%
Canada	15	0.5%
Australia	14	0.5%
Ireland	14	0.5%
Germany	13	0.4%
South Africa	12	0.4%
Portugal	9	0.3%
Brazil	8	0.3%
Spain	8	0.3%
Greece	7	0.2%
Singapore	7	0.2%
Finland	6	0.2%
Kuwait	6	0.2%

Norway	6	0.2%
Liechtenstein	5	0.2%
Denmark	4	0.1%
Gibraltar	4	0.1%
New Zealand	4	0.1%
US Virgin Islands	3	0.1%
Argentina	2	0.1%
Barbados	2	0.1%
Isle Of Man	2	0.1%
Japan	2	0.1%
Panama	2	0.1%
Russia	2	0.1%
Iceland	1	0.0%
St. Vincent & The Grenadines	1	0.0%
Taiwan	1	0.0%
Grand Total	3,073	100.0%

The information given herein is correct as at: [date] and has been completed by [name of person], [position within company]

Appendix 6

AIMA's Funds of Hedge Funds Managers Due Diligence Questionnaire



AIMA'S ILLUSTRATIVE QUESTIONNAIRE FOR DUE DILIGENCE OF FUNDS OF HEDGE FUNDS MANAGERS

Published by
The Alternative Investment Management Association Limited (AIMA)

IMPORTANT NOTE

- All/any reference to AIMA must be removed from this document once any question is amended or information is added, including details of a company/fund - with the exception of one phrase: "This questionnaire is based on AIMA's Illustrative Questionnaire for the Due Diligence of [name]".
- AIMA is distributing this Questionnaire in its current form to its member companies and institutional investors on a confidential basis as a service to the hedge fund industry. This Questionnaire may not be distributed by any other party without AIMA's permission.
- The copyright in this questionnaire belongs to AIMA. You may copy the questionnaire for your own company's use and may distribute it for the purpose of a due diligence review, but you may not distribute nor copy it for any other purpose without the prior written consent of AIMA.

This questionnaire is based on AIMA's Illustrative Questionnaire for the Due Diligence of Funds of Hedge Funds Managers (2009)

AIMA's Illustrative Questionnaire for Due Diligence of FUNDS OF HEDGE FUNDS' MANAGERS

The purpose of this document is to serve as a guide to investors in their relations with fund of hedge funds managers. This due diligence questionnaire is an unavoidable process that investors must follow in order to choose a manager. Not all of the following questions are applicable to all managers but we recommend that you ask as many questions as possible before making a decision.

DISCLAIMER

Whilst AIMA has used all reasonable efforts to produce a questionnaire of general application in connection with a due diligence appraisal of fund of hedge funds managers, in any particular case an investor is likely to have its own individual requirements and each fund of hedge funds manager its own characteristics. As a result, prior to any individual investor sending out the questionnaire, it is strongly recommended that the questions are reviewed and, where necessary, amended to suit its own requirements and its state of knowledge of the fund of hedge funds manager's operations.

In addition, you should review with your legal counsel and other advisors the value of the responses and to what extent, if any, you may rely upon such responses. The contractual terms of an investment in any fund of hedge funds will normally be confined to the terms of the application or subscription documents, prospectus, private placement memorandum or other offering document and the constitutional documents of the fund of hedge funds. In order to obtain the best possible information on any specific fund of hedge funds manager, additional questions should be raised to clarify any point of uncertainty, and where practicable verbal examination should be undertaken. In particular, AIMA recommends that in respect of special areas of concern, such as fund performance or risk profile, independent third party data should, if possible, be obtained in order to verify these facts.

None of AIMA, its officers, employees or agents makes any representation or warranty, express or implied, as to the adequacy, completeness or correctness of the questionnaire. No liability whatsoever is accepted by AIMA, its officers, employees or agents for any loss howsoever arising from any use of this questionnaire or its contents or otherwise arising in connection therewith. For the avoidance of doubt, note that by providing this questionnaire, AIMA does not act as legal counsel in any jurisdiction.

Other AIMA questionnaires available in this series are for the selection of:

- *Hedge Fund Managers*
- *Managed Futures Managers*
- *Fund Administration (for Managers)*
- *Fund Administration (for Investors)*
- *Prime Brokers*

This questionnaire is based on AIMA's Illustrative Questionnaire for the Due Diligence of Funds of Hedge Funds Managers (2009)

AIMA's Illustrative Questionnaire for Due Diligence of FUNDS OF HEDGE FUNDS' MANAGERS

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The information given herein is correct as at: [date] and has been completed by [name of person], [position within company]

NB: THE INFORMATION GIVEN HEREIN IS CORRECT AS AT TUESDAY, 28 APRIL 2009

NAVIGATING THIS DOCUMENT	Please use tab-key or point mouse to the beginning of the input field
INPUTTING DATA	The size of the fields will automatically adjust to the length of your input
UPDATING PAGE NUMBERS	As this questionnaire is completed (thus grows), page numbers on the index page will NOT be updated automatically. To update the index page (which is a table), click to the left of the table (at any point) then press F9 on your keyboard. Select the first option: to update page numbers only

1 BACKGROUND INFORMATION

1.1 CONTACT INFORMATION

1.1.1	Company name:	
1.1.2	Address:	
1.1.3	Telephone:	
1.1.4	Fax:	
1.1.5	E-mail:	
1.1.6	Website:	
1.1.7	Name of contacts:	
1.1.8	Title of contacts:	
1.1.9	Telephone of contacts:	
1.1.10	E-mail of contacts:	

1.2 COMPANY

1.2.1	Please give a brief history of the company and, if applicable, group structure:	
1.2.2	What type of legal entity is your company?	
1.2.3	Provide a chart of the legal structure of the company and list all branch or affiliate offices:	
1.2.4	Provide details of the company's current ownership structure:	
1.2.5	Detail any changes in the last 3 years:	
1.2.6	Are there any plans for further ownership changes?	
1.2.7	Provide a short history of the company with the most important milestones:	

1.3 CORPORATE GOVERNANCE

1.3.1	Who are the Directors? Please provide details of relationship to the firm.	
1.3.2	Are there Independent Directors? Please provide details.	
1.3.3	How often does the	

This questionnaire is based on AIMA's Illustrative Questionnaire for the Due Diligence of Funds of Hedge Funds Managers (2009)

The information given herein is correct as at: [date] and has been completed by [name of person], [position within company]

	Board/Governing Body meet?	
1.4 STAFF INFORMATION		
1.4.1	Number of permanent staff:	
1.4.2	Number of investment professionals:	
1.4.3	State the number of employees in your company as at year end for the last 5 years:	
1.4.4	Provide an organisation chart including the different departments and the number of permanent employees for each:	
1.4.5	Explain any significant employee turnover including listing joiners/leavers of key staff over last (two) years:	
1.4.6	How does the company attract new people?	
1.4.7	Explain the compensation scheme for key people (particularly the bonus structure and the manager's share of the performance fee):	
1.4.8	Provide a brief background of key personnel in each area (education, professional background):	
1.4.9	Please discuss possible retirement of key individuals with succession plans:	
1.5 ASSET MANAGEMENT ACTIVITIES		
1.5.1	Total AUM in the Fund(s) of Hedge Funds (FoHF) (unleveraged).	
1.5.2	Total AUM in the FoHF (leveraged).	
1.5.3	Show the growth of assets under management (total and breakdown by style) over the last 5 years:	
1.5.4	Show your FoHF net in/out flows over the last two years.	
1.5.5	Please provide your highest historical inflow and outflow in a given quarter.	
1.5.6	Provide your FoHF AUM breakdown in %: a. direct investments vs. structured products and b. by client type (insurance companies, pension funds, corporates, banks for	

This questionnaire is based on AIMA's Illustrative Questionnaire for the Due Diligence of Funds of Hedge Funds Managers (2009)

The information given herein is correct as at: [date] and has been completed by [name of person], [position within company]

	private clients, banks for own account, family offices).	
1.5.7	Does the company conduct any business other than asset management? (i.e., as anything related to having business with the FoHF?) If so, please state the nature of those businesses:	
1.5.8	Apart from FoHFs, does the company manage other products? If yes, provide the breakdown of assets (USD/%) for each product family (traditional, FoHF, HF, etc.):	
1.5.9	Does the company manage any direct hedge funds? If so, please describe. Does your FoHF invest in them?	
1.5.10	Does the company sponsor or have any ownership interest in hedge fund managers who are not employees of the company? If so, does the FoHF invest in these managers?	
1.5.11	Which investor group does the company primarily target?	
1.5.12	Provide a breakdown of assets under management by: <ul style="list-style-type: none"> • Strategy: • Country: • Client group: 	
1.5.13	What is the percentage of assets under management represented by your largest client, and by your 5 largest clients? Provide a list of the 5 main clients (incl. size of assets, duration of client relationship):	

2 INVESTMENT PHILOSOPHY

2.1	Describe your investment philosophy:	
2.2	Is leverage applied to the FoHF? If so, please provide details:	

3 INVESTMENT PROCESS

3.1	Describe your investment approach:	
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4 STRATEGY AND STYLE ALLOCATION

4.1	Describe your asset/style	
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This questionnaire is based on AIMA's Illustrative Questionnaire for the Due Diligence of Funds of Hedge Funds Managers (2009)

The information given herein is correct as at: [date] and has been completed by [name of person], [position within company]

	allocation process:	
4.2	Which strategies do you invest in?	
4.3	Which strategies do you avoid? (And why?)	
4.4	What is the company's competitive edge in the strategy and style allocation process?	
4.5	On what basis and when does the company define and change the asset allocation of the portfolios?	
4.6	Do investment guidelines/limits exist for all products? If so, please provide sample:	
4.7	Can the guidelines be altered? If so, how?	
4.8	For non-standard products, to what extent can the investor be involved in the asset allocation process?	
5 DUE DILIGENCE/MANAGER SELECTION		
5.1.1	Summarise your manager selection process:	
5.1.2	Please describe, in detail, the company's due diligence process including the investment, legal and compliance, and operational due diligence procedures. Provide examples of reports and working papers, where available:	
5.1.3	For each step of the process, how is decision making structured? Who is the ultimate decision maker?	
5.1.4	Please list the underlying hedge fund documentation that you review:	
5.1.5	What level of transparency do you require from the managers/funds in the portfolio?	
5.1.6	Where does your due diligence process differ from that of others in the marketplace?	
5.1.7	How many managers/funds are you currently invested with? If there is a separate approved list, how many funds are on the approved list?	
5.1.8	How many new managers/funds do you	

This questionnaire is based on AIMA's Illustrative Questionnaire for the Due Diligence of Funds of Hedge Funds Managers (2009)

The information given herein is correct as at: [date] and has been completed by [name of person], [position within company]

	analyse per year?	
5.1.9	How many managers/funds are approved per year?	
5.1.10	What is the average time scale of the manager selection process?	
5.1.11	Do you conduct on-site visits with the managers?	
5.1.12	Are all visits written up in structured reports?	
5.1.13	How many visits to a manager will you make prior to making an investment?	
5.1.14	How much time is spent with each manager during the due diligence process: <ul style="list-style-type: none"> • Before initial investment? • After initial investment? 	
5.1.15	What are the main reasons for the exclusion of particular managers from a portfolio?	
5.1.16	What were your biggest errors (if any) in 2008 and past years in terms of manager selection? What have you changed since then in order to improve your process?	
5.2 OPERATIONAL DUE DILIGENCE (ODD)		
5.2.1	Do you have a dedicated operational due diligence team?	
5.2.2	What is the size and qualifications of the team? Provide a sample ODD checklist if used.	
5.2.3	Do you perform reference checks on the manager? If so, how are these done?	
5.2.4	Do you perform ODD on the middle and back office operations? If so, please describe:	
5.2.5	Explain both the ODD prior to investment and the ongoing ODD after investment (if any). Are all visits written up in structured reports?	
5.2.6	Do you perform due diligence checks on the administrator or any other service provider to the targeted funds? If so, please describe:	
5.2.7	How do you analyse and monitor counterparty risk?	

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The information given herein is correct as at: [date] and has been completed by [name of person], [position within company]

5.2.8	Do you contact the outside audit company prior to approval?	
5.2.9	What were your biggest errors (if any) in 2008 and past years in terms of ODD? What have you changed since then in order to improve your process?	
5.3 CAPACITY		
5.3.1	How many managers are currently on your approved list?	
5.3.2	How much capacity is available from managers on the approved list/you are invested with? Please provide breakdown by strategy:	
5.3.3	How does the company secure and expand capacity with underlying hedge fund managers?	
6 PORTFOLIO CONSTRUCTION		
6.1	Describe the portfolio construction process.	
6.2	What is your expected and historical attribution from style allocation and manager selection? Please explain if significant.	
6.3	Is there an investment committee that approves portfolio allocations? If applicable, please describe its set up and authority:	
6.4	How often are portfolios rebalanced?	
6.5	State the average turnover of managers within the portfolios:	
6.6	Does the turnover of managers in different portfolios vary substantially?	
6.7	What are the main reasons for the exclusion of particular managers from a portfolio?	
6.8	How do you deal with capacity constraints related to portfolio construction?	
7 RESEARCH		
7.1	Define the objectives of your research team. Specify the resources allocated to this activity.	

This questionnaire is based on AIMA's Illustrative Questionnaire for the Due Diligence of Funds of Hedge Funds Managers (2009)

The information given herein is correct as at: [date] and has been completed by [name of person], [position within company]

7.2	In which areas does the company use external research and which sources do you employ?	
7.3	Does the company publish regularly in the press or commission any research/academic papers? Provide samples:	
8 RISK MANAGEMENT		
8.1	Describe your risk management philosophy:	
8.2	Describe how risk management is structured within your organisation:	
8.3	What risk management concepts does the company apply to its underlying managers/funds?	
8.4	Does the company maintain a written risk management policy? If yes, provide a copy:	
8.5	Does the company use any formal risk limits? Or informal risk guidelines? If so, please describe how they are established and used.	
8.6	Are stop-loss policies used? If so, please describe:	
8.7	Does the company maintain a risk management system including operational, legal, reputational and business risks? If so, please describe:	
8.8	Do the underlying hedge fund managers provide portfolio transparency? Please describe the extent, timeliness and frequency of this:	
8.9	Describe the company's quantitative risk management tools:	
8.10	Describe any concentration limits you have at individual manager level and strategy level.	
8.11	How are liquidity provisions monitored and controlled?	
8.12	How do you manage the liquidity risk in your portfolio? State the policy implemented in terms of liquidity management. Have you defined guidelines in terms of acceptable liquidity matching?	
8.13	Please describe the credit	

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	facilities you have for the fund including the foreign exchange (FX) hedging, if any, and the process to monitor them.	
8.14	Has a manager included in one of the company's portfolios ever gone out of business ("blow ups") or suffered significant drawdown or fraud? If yes, please describe and explain the lessons learnt from that experience and how they have been applied to your business.	
9 OPERATIONAL RISK		
9.1	How does the company define operational risk?	
9.2	Does the company have an operational risk management framework? Does the framework consider how the company identifies, assesses, monitors and controls operational risks?	
9.3	Are the employees responsible for the operational risk framework adequately independent from the business and appropriately trained? (For example, does the company have a risk or internal audit function that is responsible for the framework?)	
9.4	Does the board of directors approve and regularly review the operational risk management framework?	
9.5	Who is responsible for implementing the operational risk framework? Are there clear lines of responsibility across senior management?	
9.6	Outline the roles and tasks of the members of your operations team (including reconciliation and valuation processes).	
9.7	How does the company ensure that employees understand their responsibilities for implementing the operational risk framework?	
9.8	What ongoing assurance does the firm provide to clients	

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The information given herein is correct as at: [date] and has been completed by [name of person], [position within company]

	over the effectiveness of its operational risk framework? If a SAS70 or FRAG 21 (being replaced by AAF 01/06) has been completed please list the key weaknesses identified in the last 5 years.	
10 OPERATIONAL RISK FOR DELEGATED FUNCTIONS		
10.1	What due diligence process does the company perform prior to the appointment of a contracted service provider? Please specify if this process differs for different service providers e.g., custodian and administrator.	
10.2	Are service level agreements in place between the company and its contracted service providers? If so, how does the company monitor services against the prescribed standards?	
10.3	Does the company perform periodic reviews of the contracted service providers?	
10.4	What ongoing assurance does the firm perform over the effectiveness of the controls at contracted service providers?	
11 ADMINISTRATION/OPERATIONS		
11.1 ADMINISTRATION		
11.1.1	How often is the NAV calculated/estimated?	
11.1.2	Is the FoHF administration performed in-house? If performed in-house: <ul style="list-style-type: none"> • Explain why this role is performed in-house. • What are the tasks of the FoHF administration? • Does an independent party review these calculations? • What systems are used for FoHF administration? 	
11.1.3	Are the computer systems developed in-house or does the company use standard products?	
11.1.4	If services are delegated to outside contractors: <ul style="list-style-type: none"> • Which tasks are fulfilled by external service providers (include names of 	

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The information given herein is correct as at: [date] and has been completed by [name of person], [position within company]

	<p>companies)?</p> <ul style="list-style-type: none"> • Detail the duration of the relationship: • Which services does your administrator provide (e.g., direct reporting to investors)? 	
11.1.5	<p>Please provide contact names, telephone and email for the following functions:</p> <ul style="list-style-type: none"> • Financial Reporting • Valuations/Fund Accounting 	
11.1.6	<p>Please outline the process for valuations, reconciliations and confirmation of assets.</p>	
11.1.7	<p>What is your policy with regards to the pricing of illiquid positions (i.e., side pockets, suspended redemptions)?</p>	
11.1.8	<p>Have you experienced any material discrepancy between your administrator and your own internal estimate on NAV calculation? If so, please describe.</p>	
11.2 SERVICE PROVIDERS		
11.2.1	<p>Provide a list of professional counterparties the company maintains a business relationship with:</p> <ul style="list-style-type: none"> • Legal advisors: • Auditors: • Banks: • External marketers: • Other: 	
11.2.2	<p>Do all the FoHFs run by the Company have the same service providers? If not, why?</p>	
11.2.3	<p>Have there been any changes in service providers (including administrators) to the FoHF in the last 5 year? If so, why?</p>	
11.2.4	<p>Please provide details of the fees paid to your service providers, on an annual basis (including the administrator).</p>	
11.3 COMPLIANCE/REGULATION		
11.3.1	<p>Does the company have a full time compliance officer?</p>	
11.3.2	<p>Describe how compliance is structured within your organisation:</p>	
11.3.3	<p>Does a dedicated compliance team exist? Does the</p>	

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The information given herein is correct as at: [date] and has been completed by [name of person], [position within company]

	company maintain a written compliance manual? If yes, please provide details:	
11.3.4	When was the manual last updated?	
11.3.5	Is the company registered with any regulatory and/or supervisory bodies?	
11.3.6	Please specify the date of the most recent regulatory inspection, if any:	
11.3.7	Are there any lawsuits pending against the company?	
11.3.8	Is your company a member of AIMA or any other relevant trade association?	
11.4	CONFLICT OF INTEREST	
11.4.1	How does the company ensure an alignment of interests between the company as FoHF manager and the investor?	
11.4.2	Are key people invested in the funds? If yes, under which terms and conditions?	
11.4.3	Are there any potential conflicts of interests the investor should be aware of?	
	Does the firm and/or FoHFs have any distribution agreement with managers and/or distributors?	
12	ANTI-MONEY LAUNDERING	
12.1	Confirm that the company has established Anti-money Laundering (AML) procedures:	
12.2	Please advise which jurisdiction's regulations you comply with:	
12.3	Please advise who your AML Officer is:	
12.4	Elaborate on the procedure to ensure compliance with AML policies:	
12.5	Please provide a summary of your AML procedures.	

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The information given herein is correct as at: [date] and has been completed by [name of person], [position within company]

12.6	<p>If this function is delegated to an outside contractor (i.e., administrator):</p> <ul style="list-style-type: none"> • Include the name of the company: • Detail the duration of the relationship: • How do you ensure that their AML procedures are in compliance with industry practice? 	
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13 BUSINESS CONTINUITY/DISASTER RECOVERY

13.1	<p>Does the company have a formal business continuity management plan? Please describe the basic provisions:</p>	
13.2	<p>What contingency plans do you have in terms of:</p> <ul style="list-style-type: none"> • Computer system fault? • Incapacitated investment decision makers? • Presence of in-house computer technician? • Back-up systems? 	

14 INSURANCE

14.1	<p>Do you currently hold insurance for the following:</p> <ol style="list-style-type: none"> 1. Directors' and Officers' Liability? <ol style="list-style-type: none"> a) For the FoHFs b) For the management companies 2. Professional Indemnity or Errors and Omissions? 3. Crime (Employee fidelity/third party fraud)? 4. Key Person Insurance? <p><i>N.B.: if you are not restricted from disclosing such information under your policy(ies)</i></p>	
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15 PRODUCT INFORMATION

(if necessary please complete one sheet for each of your fund products)

15.1	<p>Provide a short description of your flagship products or most representative products, including:</p> <ul style="list-style-type: none"> • Investment objective, return, risk: • Target investors: 	
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The information given herein is correct as at: [date] and has been completed by [name of person], [position within company]

	<ul style="list-style-type: none"> • Breakdown of current investor base: • Legal structure: • Domicile of FoHF: • Currency share classes: • Investment universe (strategy/geography) • Asset allocation: • Number of funds in the portfolio: • Current size: • Date of inception: • Total standard fee structure: • Liquidity: • Do your products have the facility to impose constraints such as gates, side pockets etc.? If so please complete section 15.5. • Are any investors granted preferential liquidity terms? If so, describe the terms and % of NAV. • Conditions for Subscriptions and Redemptions: • Minimum investment: <p>Please provide this information for each of your products. Alternatively, provide offering memoranda for your flagship products.</p>	
15.2	Does the company specialise in any product or group of products? If so, please describe:	
15.3	List your other FoHFs with their key characteristics (e.g., strategy)?	
15.4	List the FoHFs that you have previously operated which have been subsequently liquidated. Please describe the reasons for liquidation.	
15.5	List the FoHFs that you operate currently, or have operated in the past, which have either suspended redemptions; imposed gates or created side pockets.	
15.6	Are there any independent FoHF directors? Please provide details:	

This questionnaire is based on AIMA's Illustrative Questionnaire for the Due Diligence of Funds of Hedge Funds Managers (2009)

The information given herein is correct as at: [date] and has been completed by [name of person], [position within company]

15.7	How often does the Board/Governing Body meet?	
15.8	Please provide roles and responsibilities of the Directors.	

16 PERFORMANCE

16.1	Provide historical performance for all your products (actual only) since inception net of standard fees (in electronic form) including: <ul style="list-style-type: none"> • Monthly returns: • Standard deviation (annualised): • Three largest drawdowns and recovery periods: • Percentage of positive/negative months: 	
16.2	Has this track record been audited? By whom? When?	
16.3	Is the company AIMR/GIPS compliant? If so, please provide a copy of the compliance presentation. Have these presentations been verified by a third party? Please provide a copy of the verification report.	
16.4	Please describe the payment process of your performance fees for your FoHFs and their timings in relation to the sign off of the annual auditor's report.	

17 CLIENT INFORMATION/REPORTING

17.1	What is your client reporting policy? Address topics such as level of transparency, frequency and timeliness:	
17.2	Please provide the details of the content of your reporting (performance, risk, allocation, liquidity, etc.).	
17.3	What is the normal method of communication with your clients:	
17.4	Provide sample reports that are sent to investors.	
17.5	Can investors receive customised reports?	
17.6	Are audited reports available to the investor? Please provide sample.	
17.7	How often will you review a	

This questionnaire is based on AIMA's Illustrative Questionnaire for the Due Diligence of Funds of Hedge Funds Managers (2009)

The information given herein is correct as at: [date] and has been completed by [name of person], [position within company]

	portfolio with a client?	
17.8	Do you provide formal client training?	
18 TAXATION		
18.1	On what basis does the FoHF maintain that it is managed and controlled, and therefore tax resident, outside the UK?	
18.2	How has the company satisfied itself that the conditions on the Investment Manager Exemption have been met or that it is not the Permanent Establishment of the fund?	
18.3	Has the FoHF paid tax to any authority before? If so, what is it and how much?	
18.4	Has the FoHF been advised by any advisor (e.g., auditor, legal counsel) on a specific tax matter? If so, what is the conclusion?	

Please attach your most recent disclosure document, information memorandum, and marketing literature.

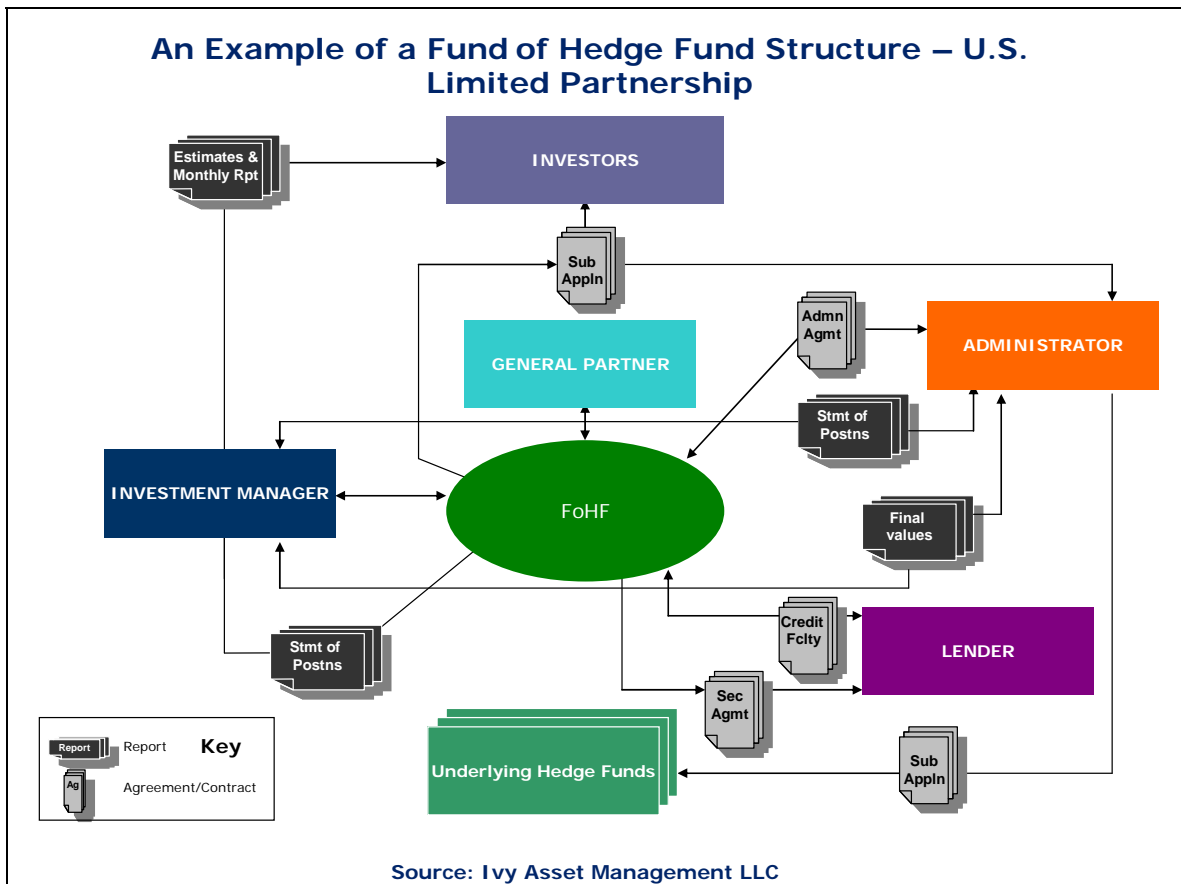
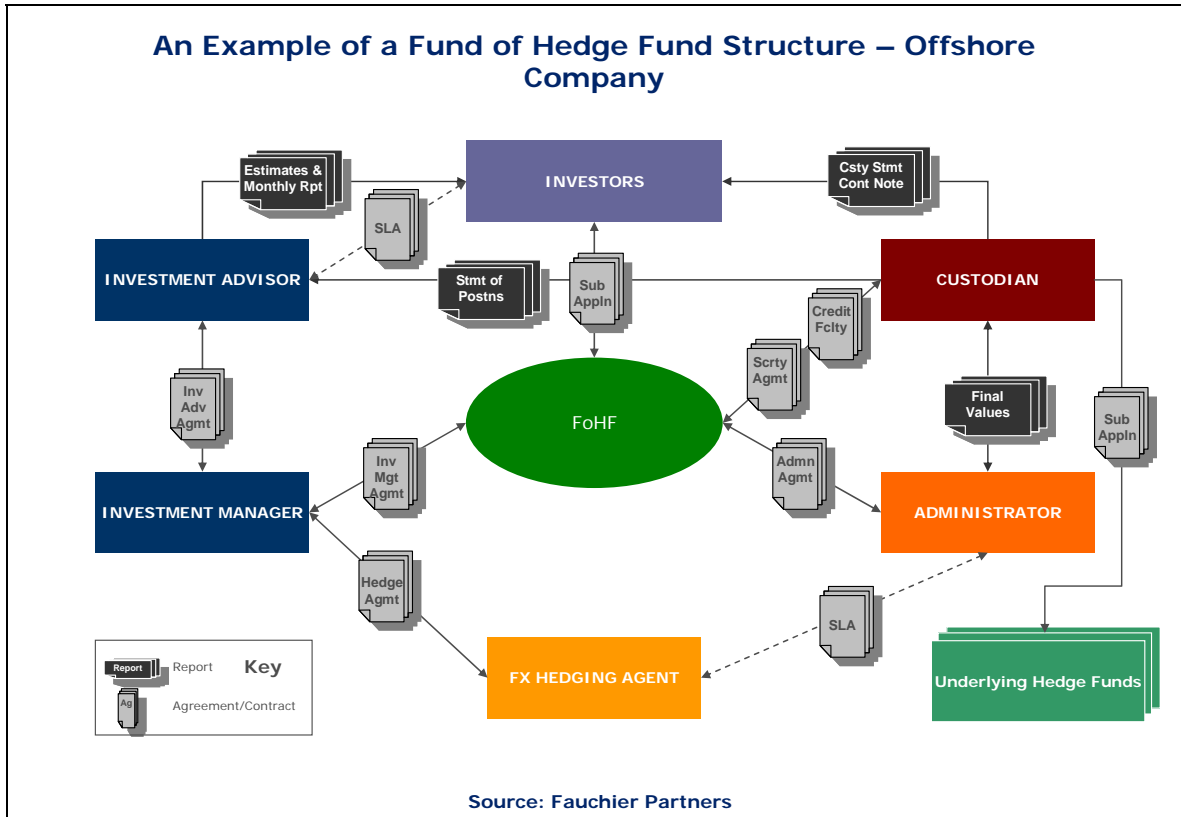
In the event of amendments to the aforementioned documents, notably the memorandum, please ensure that we will receive those directly from you within reasonable time, as well as copies of proxies and notification of the Annual General Meeting (the latter only for information purposes).

Please state the name and title of the officer at your company who has prepared and reviewed this questionnaire.

Name:	
Date:	
Position:	

This questionnaire is based on AIMA's Illustrative Questionnaire for the Due Diligence of Funds of Hedge Funds Managers (2009)

Below are illustrative examples of structures for Funds of Hedge Funds; one for an offshore company, one for a limited partnership. They are not intended to be prescriptive and may vary across different jurisdictions and business models.



Name	Definition
Articles of association	The legal document filed with a state to create a corporation. It establishes a corporation's purpose and structure. It conveys the corporation's name, primary place of business, names of directors, and the amounts and types of stock it is authorised to issue. Also called a memorandum and articles of incorporation, in certain jurisdictions.
Administrator	An entity which provides a range of services to the funds under the terms of an agreement with it (often in the form of a service level agreement), which can include shareholder services, registrar and anti-money laundering services, reconciliation services and record keeping functions. Some administrators offer "integrated" solutions which allow investment managers to outsource some of their own back office functions.
Asset allocation	The structure of a portfolio - namely the allocation of specific portions of it across different asset classes, i.e., securities, property, cash, fixed interest, fund strategies etc.
Auditor	The auditor issues a written opinion upon the fair presentation of the funds annual financial statements, in accordance with the funds applicable accounting and auditing standards, on the basis of a year-end audit of the funds books and records.
Bridge financing	A method of financing, used to maintain liquidity while waiting for an inflow of cash. In the case of a Fund of Hedge Funds, it may mean that it wishes to invest in an underlying hedge fund, but will not be able to finance the subscription until it receives the proceeds of another underlying hedge fund that it has redeemed from.
Business risk	The risk that is involved in the operational and management side of a fund management business and distinct from risks associated with the trading or portfolio management functions.
Capacity	The amount of investment capital that can be comfortably absorbed by an investment manager or strategy without a diminishing of returns. A widely used indication of whether or not an investment manager or strategy faces capacity constraints is to analyse the degree to which they experience slippage (see Slippage) in the execution of their strategy or trades. There are a number of factors that may limit investment, such as the size of the underlying market and its liquidity. The investor should establish limitations to specific fund strategies.
Capital adequacy	Measure of the financial strength of a fund management firm, usually expressed as a ratio of its capital to its assets.
Capital guarantee	Also known as principal protection, it is an arrangement or mechanism built into an investment product whereby investors are generally assured that the capital value of their initial investment is secure and that at least this amount will be returned to them when such a product reaches its maturity date, but the investors are exposed to the risk of the guarantor. Principal protection features can take a variety of forms, including capital guarantees provided by banks.

Name	Definition
Capital introduction teams	A department within a prime broker that introduces its hedge fund clients to qualified hedge fund investors (e.g., Funds of Hedge Funds) who have an interest in exploring new opportunities to make hedge fund investments.
Cash management	Cash management is an investment discipline used by entities of all kinds to ensure liquidity and to maximise returns on cash balances. The five key components of effective cash management are: collection, disbursement, concentration, investment and information control. For hedge funds and Funds of Hedge Funds, cash management, if effectively employed, can play an integral part in the overall profitability of the fund.
Closed fund	A hedge fund or open-end mutual fund that has temporarily or permanently stopped accepting capital from investors, usually due to rapid asset growth. Not to be confused with a closed-end fund.
Closed-end fund	A fund with a fixed number of shares outstanding that may be listed on an exchange and publicly traded at a premium or discount to the fund's net asset value. Not to be confused with a closed fund.
Compartment structure	Also known as the umbrella fund structure (see Umbrella fund). It is a single legal entity but has several distinct sub-funds which in effect are traded as individual investment funds. This type of arrangement originated in the European investment management industry, most notably with the SICAV (an open-ended collective investment scheme). Umbrella funds can be very advantageous for investors. Being based offshore, umbrella funds can pay dividends gross e.g., without the deduction of tax at the basic rate (as is the case with unit trusts). Most umbrella funds give investors the opportunity to change their investment strategy by shifting money among the different sub-funds, sometimes at minimal cost.
Compliance consultant	Compliance consultants are third party service providers who assist the compliance officer at a fund management firm in ensuring that relevant regulations are adhered to and appropriate procedures and processes are in place to maintain compliance and its on-going monitoring.
Constitutive documents	The constitutive documents of the fund contains the following information: full and brief names of the company; details on the structure of the fund, including requirements for the scheme; appointment of the trustee, administrator; investment and borrowing restrictions; valuation of property and pricing; dealing, suspension and deferral of dealing; fees and charges; meetings and voting; disclosure of affiliated entities and transactions; distribution policy and distribution date; annual accounting period; modifications of the constitutive documents and termination of fund.
Contagion risk	The spill over effect of shocks from one or more firms to other firms.
Counterparty	The opposite party in a bilateral agreement, contract, or transaction. In the retail foreign exchange (or FX) context, the party to which a retail customer sends its funds.
Cross default provisions	These are provisions in a bond indenture or loan agreement that puts the borrower in default if the borrower defaults on another obligation. It is also known as “cross acceleration”.

Name	Definition
Custodian	A bank, trust company or other financial institution that holds and protects a fund's or Funds of Hedge Funds assets and provides other services, including collecting money from investors, distributing redemption proceeds, maintaining margin accounts, registering investments and exercising options.
DDQs (due diligence questionnaires), RFPs (request for proposal), or RFIs (request for information)	These form part of an investment manager's due diligence process and are given to underlying hedge funds by their prospective investors, e.g., pension funds, investment consultants for completion.
Directors' and officers' liability insurance	Insurance payable to the directors and officers of a company, or to the corporation itself, to cover damages or defence costs in the event they are sued for wrongful acts while they were with that company.
Double taxation treaties	Double taxation treaties are conventions between two countries that aim to eliminate the double taxation of income or gains arising in one territory and paid to residents of another territory.
Downside deviation	Considers only returns that fall below a defined Minimum Acceptable Return (MAR) rather than the arithmetic mean. For example, if the MAR were assumed to be 10%, the downside deviation would measure the variation of each period that falls below 10%.
ERISA (The Employee Retirement Income Security Act of 1974)	An American federal statute that establishes minimum standards for pension plans in private industry and provides for extensive rules on the federal income tax effects of transactions associated with employee benefit plans. ERISA is sometimes used to refer to the full body of laws regulating employee benefit plans, which are found mainly in the Internal Revenue Code and ERISA itself.
Fair value	The price at which a single unit of a security would trade between parties that do not have interests in the issue. Fair value does not take into account various premiums or discounts that would be assessed for large or illiquid positions.
FATF (Financial Action Task Force)	An inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing.
FoHF (Fund(s) of Hedge Funds)	Fund(s) of Hedge Funds is a portfolio of hedge funds offering investors exposure to a wide range of alternative investment styles and strategies.
FoHF ManCo (Fund(s) of Hedge Funds Management Company), (<i>Manager or Investment Manager</i>)	The management company of a fund that invests in a series of hedge funds. The portfolio will typically diversify across a variety of investment managers, investment strategies and subcategories.
FOREX or FX (Foreign exchange)	Refers to the over-the-counter (OTC) market for foreign exchange transactions. Also called the foreign exchange market.
Forward	A private, (OTC) derivative instrument that requires one party to sell and another party to buy a specific security or commodity at a pre-set price on an agreed upon date in the future. Similar to a futures contract, which is traded on an exchange.

Name	Definition
Four eyes principle	A requirement that an operation will be effectively conducted by at least two individuals.
Fund	The fund is a collective investment scheme, typically established in the following ways: i. In offshore jurisdictions such as the Cayman Islands, the fund will usually be established as a limited liability company. ii. Funds established under the laws of a US state such as Delaware usually take the form of a limited liability partnership. iii. Some funds in offshore jurisdictions are established as unit trusts, although this is a comparatively rare structure. The fund has legal identity but in practice decisions on its behalf will be made by its governing body.
Fund domicile	The domicile of a fund is the place where the institution behind the fund is administered and regulated.
GAAP (Generally Accepted Accounting Principles)	Conventions, rules and procedures that define accepted accounting practice, including broad guidelines as well as detailed procedures, e.g., in the US, UK and EU.
Gate	An instrument allowing the management company of a fund to limit redemptions on each redemption date, up to a maximum percentage of the fund's or Fund of Hedge Funds size.
General partner	The individual or firm that organises and manages a limited partnership, such as a hedge fund. The general partner assumes unlimited legal responsibility for the liabilities of a partnership as opposed to the limited partners whose liability is limited to the extent of their investment in the limited partnership.
GIPS (Global Investment Performance Standards)	The GIPS standards are 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.
Governing body	A governing body generally supervises and oversees the conduct of its fund's affairs, even though it will delegate day-to-day functions to other parties such as the investment manager and administrator. The composition of the governing body will depend upon the fund's structure and jurisdiction: i. A hedge fund or Fund of Hedge Funds established as a company will have a board of directors as the governing body. The board may include representatives of the investment manager, and directors selected by the investment manager, although there is an increasing trend for independent non-executive directors of stature to be appointed to hedge fund boards. ii. A hedge fund or Fund of Hedge Funds established as a partnership will usually have a general partner as governing body. Typically the general partner will be the investment manager. iii. A hedge fund or Fund of Hedge Funds established as a trust will have a trustee as the governing body. The trustee is usually an independent licensed company.
Hedge fund databases	Databases that include descriptions, data and various information regarding hedge funds or Funds of Hedge Funds. Their accuracy and reliability varies between the databases on offer.
HFSB (The Hedge Funds Standards Board Ltd)	A company limited by guarantee that has been set up to monitor conformity to the hedge fund best practice standards. As a custodian of the best practice standards it has the responsibility to ensure they are updated and refined as appropriate.

Name	Definition
High water mark	The existence of the high water mark ensures that a fund only takes performance-related fees on new profits. For example, assume a \$1,000,000 investment is made and that the fund declines by 20% in year 1, leaving \$800,000 in the fund. In year 2, the fund returns 25%, bringing the investment value back to \$1,000,000. If the fund employs a high water mark, it will not take incentive fees on the return in year 2, since the investment has never really grown, i.e., the fund did not make any new profits. The fund will only take incentive fees if the investment grows above the level of \$1,000,000.
Hurdle rate	The minimum return necessary for a fund manager to start collecting incentive/performance fees. The hurdle rate may be a fixed percentage or tied to a benchmark rate such as Libor or the one-year Treasury bill rate plus a spread. If, for example, the investment manager sets a hurdle rate equal to 5%, and the fund returns 15%, incentive/performance fees would only apply to the 10% above the hurdle rate.
Incentive/performance fee	A fee paid to a fund manager for providing returns on an investment, often by reference to a benchmark or hurdle rate. See Hurdle rate. This fee is based on net new profits and is earned by the hedge fund manager for the period concerned. It may be paid annually or quarterly but accrues monthly in the fund valuation.
Investment manager (Fund(s) of Hedge Funds Management Company or Manager)	Often referred to as the investment advisor in the United States. The investment manager enters into an agreement with the hedge fund or Fund of Hedge Funds to make investment decisions on its behalf, usually on a discretionary basis, in return for a management fee (based on NAV) and a performance fee (a percentage of NAV appreciation over a given period). The performance fee is sometimes also referred to as an incentive fee.
Investment strategy	The particular investment process employed by an investment manager in the application of an investment style.
Investor	Investors in hedge funds can be categorised in many ways but the most clear distinction is between Funds of Hedge Funds managers and direct investors: i. Funds of Hedge Funds managers: These entities manage diversified portfolios of hedge funds (usually in the form of collective investment schemes), and provide their investors with services such as fund selection and risk management in return for a fee. ii. Direct investors: Hedge funds are aimed primarily at institutional and sophisticated investors. Direct investors include pension funds (public and private), endowments, foundations and family offices.
Key-person risk	The risk that a vital member of a fund's business or its investment management team will be unable to perform its duties, possibly leading to negative performance and/or the total or partial inoperability of the business.
Leverage/gearing	The borrowed money that an investor employs to increase buying power and increase its exposure to an investment. Users of leverage seek to increase their overall invested amounts in the hope that the returns on their positions will exceed their borrowing costs. The extent of a fund's leverage is stated either as a debt-to-equity ratio or as a percentage of the fund's total assets that are funded by debt. Example: If a fund has \$1 million of equity capital and it borrows another \$2 million to bring its total assets to \$3 million, its leverage can be stated as "two times equity".

Name	Definition
Limited partnership	A statutory partnership consisting of one or more general partners and one or more limited partners. General partners are responsible for the day-to-day management of the partnership and have unlimited liability for its debts and other obligations. Limited partners play no part in the day-to-day management of the partnership and are generally passive investors in the partnership and liable to the partnership only to the extent of their investment.
Liquidity	The ease with which an investment product/fund can be sold/redeemed from, without impacting its price. Hedge funds and Funds of Hedge Funds typically offer quarterly or annual liquidity, meaning that they allow investors to redeem their shares that often.
Liquidity risk	The potential that an investor will be unable to convert its holdings into cash quickly and in large quantities without having to accept a substantial discount. The term also refers to the potential that a securities buyer will not have enough money to pay for the purchase.
Lock-up	The period of time - often one year - during which hedge fund or Funds of Hedge Funds investors are initially prohibited from redeeming their shares.
Managed account	A vehicle in which investors give an investment manager or broker discretion to buy and sell securities, futures or other instruments on their behalf, either unconditionally or with restrictions.
Management fee	A fee paid to a fund manager for managing and providing services to the fund as well as to cover certain operating expenses. Investors are typically charged separately for costs incurred for outsourced services. The management fee is generally expressed as a charge against investor assets.
Mark-to-market	The practice of valuing positions at readily available close out prices, sourced independently, e.g., by reference to exchange prices, screen prices or quotes from independent market makers.
Master-feeder fund	A common fund structure through which an investment manager sets up one or more separate “feeder fund” vehicles to accommodate different types of investors (e.g., US taxable investors, US tax-exempt investors and offshore investors), which in turn invest in a “master fund” vehicle that often is an offshore vehicle. The purpose of such an arrangement is to create a single trading vehicle for different categories of investors.
Memorandum	See Prospectus.
MFN (Most favoured nation)	A provision that affords an investor the best terms that is being offered to any other investor, present and/or future.
MiFID (Markets in Financial Instruments Directive)	A European Union law which provides a harmonised regulatory regime for investment services across the 30 member states of the European Economic Area. The main objectives of the Directive are to increase competition and consumer protection in investment services.
Minimum investment	The smallest amount that an investor is permitted to contribute to a hedge fund or a Fund of Hedge Funds as an initial investment. The amount is set by the investment manager and can be dependent on the investment manager’s/fund’s domicile’s definition of an accredited investor.

Name	Definition
NAV (Net asset value)	The market value of a fund's or a Fund of Hedge Funds total assets, minus its liabilities and intangible assets, divided by the number of its shares outstanding. The measure is used to determine prices available to investors for redemptions and subscriptions. Hedge funds and Funds of Hedge Funds typically calculate their NAVs at the end of every business day, but report them to investors on a monthly basis. Mutual funds report their NAVs daily.
Offer document	A term used for a document combining a prospectus and an investment statement.
Offering memorandum or memorandum	See Prospectus.
Open-ended fund/product	A product that is permanently open for investment. New units (shares, bonds, units) are created or dissolved as required. Investors can subscribe for or redeem these units at the prevailing net asset value per unit in accordance with the details set out in the relevant fund/product prospectus.
Operational risk	Measures the probability that investment losses will result from factors other than credit risk, market risk or liquidity risk, such as employee fraud or misconduct, errors in cash flow models, incorrect or incomplete documentation of trades or man-made disasters.
Performance/incentive fee	A fee paid to a fund manager for providing returns on an investment, often by reference to a benchmark or hurdle rate. See Hurdle rate. This fee is based on net new profits and is earned by the hedge fund manager for the period concerned. It may be paid annually or quarterly but accrues monthly in the fund valuation.
Portfolio manager	A company or individual that runs capital on behalf of an investment fund, such as a hedge fund. The portfolio manager is often the general partner of the fund's limited partnership. It may be an employee of the fund management firm, or an external entity with which the hedge fund makes a passive investment.
Prime broker	A large bank or securities firm that provides various back office and financing services to hedge funds and other professional investors. Prime brokers can provide a wide variety of services, including trade reconciliation, custody services (clearing and settlement), risk management, margin financing, securities lending for the purpose of carrying out short sales, record keeping and investor reporting. A prime brokerage relationship does not preclude hedge funds from carrying out trades with other brokers, or employing others as prime brokers.
Principal protection	Also known as a capital guarantee, it is an arrangement or mechanism built into an investment product whereby investors are assured that the capital value of their initial investment is secure and that, at least, this amount will be returned to them when such a product reaches its maturity. Principal protection features can take a variety of forms, including capital guarantees provided by banks.
Principals of Funds of Hedge Funds management business	Principals usually comprise proprietors and/or senior management of a Funds of Hedge Funds business and are responsible for all aspects of that business.

Name	Definition
Prospectus	The official document issued by a fund or Funds of Hedge Funds prior to its launch to describe the shares being offered to prospective investors. The information provided in the prospectus will be prescribed by regulators according to the type of investor to whom the fund or Funds of Hedge Funds is being promoted and the investment strategy proposed. A prospectus must generally include the characteristics of the proposed fund or Funds of Hedge Funds, such as investment objective and policies, services and fees. Investors are encouraged to read and understand a fund's or Funds of Hedge Funds prospectus before purchasing its shares.
Qualitative analysis	Analysis that uses subjective judgment to evaluate securities, fund managers, administrators, etc. based on non-financial information such as management expertise, cyclicity of industry, strength of research and development, labour relations and depth of operational infrastructure. Qualitative analysis evaluates important factors that cannot be precisely measured rather than the actual financial data about a company.
Quantitative analysis	Quantitative analysis deals with measurable factors in contrast from qualitative considerations such as the character of management.
Redemption	Liquidation of shares or interests in an investment fund.
Redemption Fee	A fee charged by the fund to investors who redeem fund shares, usually within a short space of time, intended to discourage early withdrawals.
Redemption notice period	The amount of advance notice that an investor must give a hedge fund or Funds of Hedge Funds manager before cashing in shares of the fund. Notification is required in writing.
Registrar	The organisation that maintains a registry of the share owners and number of shares held for a hedge fund. Usually the fund's administrator also performs the role of registrar.
Regulator	Independent organisation, usually governmental, that oversees financial markets, transactions and participants. Often seen as the protector of individual investors.
Re-hypothecation risk	Using collateral that secures one loan to secure a second loan. Re-hypothecation significantly increases the original lender's risk because the collateral is pledged twice.
Seed finance	This is the initial funding used to start up a hedge fund or Funds of Hedge Funds management business or, to make a first-day capital injection into a hedge fund or Fund of Hedge Funds investment vehicle.
Side letters	A letter agreement usually negotiated between an investment manager and an investor in respect of an investment in funds or Funds of Hedge Funds, containing terms which may be more preferable to those offered in the funds or Funds of Hedge Funds offer documents. Such terms may offer the investor reduced fees, special redemption rights, special reporting rights, etc.
Side pockets	A type of account mostly composed of illiquid assets used in hedge funds in order to separate illiquid assets from other more liquid investments. The "side pockets" shares are not redeemable and they may or may not be reassessed.

Name	Definition
SIPs (Single Investor Portfolios)	An investment which is specifically structured for the sole use of a single investor.
SLAs (Service Level Agreements)	The agreements between a fund or a Fund of Hedge Funds and its various service providers, including administration and prime brokerage agreements.
Slippage	The difference between the sample or target price for buying or selling an asset and the actual price at which the transaction takes place.
Spot	Market of immediate delivery of and payment for the product.
Structured product	Typically provides principal protection (see Principal protection), invests across a range of styles and investment managers, provides increased investment exposure (see Leverage) and requires a high level of structuring expertise with respect to blending investment approaches, financing, liquidity and risk management.
Style	A generic investment approach - such as equity hedge and long/short, event driven, arbitrage, global macro, or Funds of Hedge Funds - that has developed as a result of numerous investment managers aiming to exploit a particular type of market inefficiency, sharing a broadly similar conceptual understanding of that inefficiency, and employing a broadly similar investment methodology in order to extract value. Practitioners of a particular style will have their own investment process or strategy with unique distinguishing features and techniques.
Style drift	The divergence of a fund or a Fund of Hedge Funds from its stated investment style or objective. Style drift occurs for a number of reasons including, the result of the intentional portfolio investing decisions by management or a change of the investment vehicle's management.
Subscription	Investment of capital into the shares or interests in an investment fund.
Survivorship bias	An over-estimation of historic returns for the hedge fund industry that results from the tendency of poor-performing hedge funds to drop out of an index while strong performers continue to be tracked. The result is a sample of current funds that includes those that have been successful in the past, while many funds that underperformed are not included.
Systematic trading	Systematic trading strategies use rule-based trading models implemented in a systematic fashion to identify and execute trading opportunities with limited manager intervention.
Top-down allocation	An approach that seeks to assess the influence of various macro-and micro-economic factors before identifying individual investments.
Track record	The actual performance of an investment since inception, usually represented by audited monthly returns, net of fees.
Umbrella fund	Describes a collective investment scheme which is a single legal entity but has several distinct sub-funds which in effect are traded as individual investment funds (see Compartment structure).
Volatility	A statistical measurement of the rate of price change of a futures contract, security, or other instrument underlying an option.

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