Hedge Fund Code of Practice

2010
Introduction

What does this Code of Practice cover?

This Code of Practice (“the Code”) sets out best practice standards for Fund Managers of Hedge Funds in the DIFC (i.e. Fund Managers of both Public and Private Domestic Hedge Funds). These are designed to address risks inherent in the operation of Hedge Funds and are set out under 9 Principles as follows:

- Principle 1 – A Fund Manager of a Hedge Fund should have, or have access to, appropriate skills and resources to conduct the operations of the Fund (see paragraphs 3 – 6);
- Principle 2 – A Fund Manager of a Hedge Fund should develop and implement a robust and flexible investment process to suit the objectives and risk profile of its investment strategies (see paragraphs 8 – 9);
- Principle 3 – A Fund Manager of a Hedge Fund should have systems and controls to mitigate trading related risks such as price overrides and failed trades (see paragraphs 10 – 12);
- Principle 4 – A Fund Manager of a Hedge Fund should have adequate back-office systems and controls to avoid backlogs in trade confirmations (see paragraphs 13 – 15);
- Principle 5 – A Fund Manager of a Hedge Fund should have appropriate measures to identify and manage portfolio risks (see paragraphs 16 – 24);
- Principle 6 – A Fund Manager of a Hedge Fund should have adequate valuation policies and procedures to ensure integrity, accuracy and timeliness of the valuation process (see paragraphs 25 – 26);
- Principle 7 – A Fund Manager of a Hedge Fund should not have arrangements under which any material benefits or concessions are provided to some investors where it would be unfair to any other investors in the Fund (see paragraphs 27 – 28);
- Principle 8 – A Fund Manager of a Hedge Fund should have adequate systems and controls to deal with market sensitive information (see paragraphs 29); and
- Principle 9 – A Fund Manager of a Hedge Fund should not invest in an underlying Hedge Fund without appropriate due diligence (see paragraphs 30 – 32).

Why have we adopted a principles based approach?

Instead of rules, we have adopted a principles based approach for developing best practice standards. We believe that those best practice standards will promote certainty while allowing industry participants a degree of flexibility to adapt these standards to suit their particular businesses in light of changing market conditions and emerging issues.
What is the legal effect of the Code?

Hedge Funds, being Collective Investment Funds, attract a range of regulatory requirements set out primarily in the Collective Investments Law 2010 and the Collective Investment Rules 2010 (referred to as the CIF regime). This Code does not cover every, or for that matter, most aspects of the CIF regime which apply to a Hedge Fund being a Collective Investment Fund (Fund).

Because what is set out in this Code is only best practice standards, and does not cover many aspects of the CIF regime, mere compliance with the Code is neither a substitute for full compliance with the CIF regime nor the only way to comply with the requirements to which the standards relate. However, compliance with these standards would provide strong evidence to support compliance with the requirements to which the best practice standards relate. For convenience, we have indentified some of the key requirements to which the best practice standards relate under the relevant Principles. See Table A for a more detailed list of the legal obligations to which the best practice standards in the Code relate.

We note that in some jurisdictions, a ‘comply or explain’ approach to best practice standards may be adopted. We will cooperate with any firm that seeks to follow that approach, whether only for the purposes of the CIF regime or as part of a world-wide strategy.

Terms used in this Code have the same meaning as defined in the GLO Module of the DFSA Rulebook. See Table B for some of those definitions.
Managing operational risk

1. In the search for higher returns, Fund Managers of Hedge Funds employ innovative and complex investment strategies and financial instruments. By using complex investment strategies and products, Fund Managers of Hedge Funds expose investors to portfolio risks such as volatility, liquidity, market and counterparty risks. Implicit in investors’ acceptance of exposure to such portfolio risks is their greater reliance on the ability of Fund Managers to manage these risks effectively.

2. However, the more complex and sophisticated the investment strategies and products involved, the more difficult it becomes to subject the Fund Manager’s performance to objective scrutiny and assessment by all stakeholders, including investors and counterparties. Therefore, risks to the operational ability of the Fund Manager assume a greater significance in Hedge Fund operations than in other conventional Funds. The best practice standards under Principles 1 – 4 are designed to address some of these operational risks associated with skills and resources, investment strategy and trading process and systems and controls, including back office functions, of Hedge Fund Managers by bringing a degree of objectivity and transparency to the processes involved.

Resources and skills

Principle 1: A Fund Manager of a Hedge Fund should have, or have access to, appropriate skills and resources to conduct the operations of the Fund

3. Fund Managers of Hedge Funds often rely on specialist service providers such as prime brokers, investment managers and fund administrators and a small number of in-house specialists to conduct their operations. This raises key risks of lack or loss of relevant expertise at the Fund Manager and third party service provider level, which can be particularly critical where the investment strategies and processes adopted by a Hedge Fund are complex and therefore alternative sources of relevant expertise may not be readily available.

4. Fund Managers of Hedge Funds are already subject to specific obligations to ensure appropriate due diligence and monitoring of third party service providers, particularly where relying on fund administrators and prime brokers (see CIR Rule 13.6.1). While suitable measures to meet these obligations could vary depending on the nature and scale of operations, at a minimum, a Fund Manager should have:

(a) an appropriate level of skills or access to such skills at senior management level relating to the specific investment strategies and products and their associated risks;

(b) identified measures to mitigate the risk of undue dependence on key individuals, such as alternative sources of relevant expertise and cross-training arrangements to ‘skill-up’ other individuals; and

(c) the ability to assess and monitor the level of expertise, resources and skills of third party service providers on whose skills and expertise they rely for the successful operation of the Hedge Fund, such as prime brokers, investment managers and fund administrators.
Prime broker and other arrangements

5. Services provided by a prime broker are often critical to the operation of a Hedge Fund. Fund Managers rely on both the expertise and stock lending and other funding arrangements provided by prime brokers to implement investment strategies of the Fund. Before entering into a prime broker arrangement, a Fund Manager of a Hedge Fund should at a minimum consider:

(a) the services the prospective prime broker proposes to provide and its capacity to deliver those services. It would generally be prudent to check the track record of the prime broker in providing similar services;

(b) the adequacy of the infrastructure and systems available to the prime broker to deliver the services, for example, whether and to what extent the processes of delivery between the Investment Manager, other service providers such as Fund Administrator and the prime broker are automated;

(c) interest rate and fee structures of the prime broker, and comparison with interest and fee structures offered by other sources, including other prime brokers;

(d) securities lending structure, such as the type of collateral required and the cost of such arrangements;

(e) material provisions of the prime brokerage documentation such as margin calls, synthetic products trading, segregation of assets and events of default and their impact (such as set off arrangements) on the proposed trading activities of the Hedge Fund;

(f) the prime broker’s familiarity with, and appropriate internal resources to service, the relevant investment strategy;

(g) the amount of leverage the prime broker is prepared to provide to the Fund and the basis on which this is provided;

(h) the extent of segregation and ownership of assets and whether it is consistent with the particular legal requirements in the DIFC, particularly where the prime broker provides similar services to other fund managers; and

(i) the credit worthiness of the prime broker, including the regulatory regime applicable to the prime broker, any credit rating and the adequacy of its business continuity plans.

6. When using other types of operation critical third party service providers such as investment managers, specialist traders and fund administrators, Fund Managers of Hedge Funds should adopt similar procedures, subject to any adjustments needed.

Investment strategy and process

7. Investment strategies of Hedge Funds often involve short selling, use of over the counter (i.e. OTC) derivatives, investments in distressed debt and various forms of leverage, which may give rise to higher risks than in other more conventional Funds taking long only positions. Best practice standards set out under Principles 2 and 3 are designed to address some of the operational risks that may affect the Fund Manager’s ability to manage the processes involved in giving effect to its investment strategy.
Principle 2: A Fund Manager of a Hedge Fund should develop and implement a robust and flexible investment process to suit the objectives and risk profile of its investment strategies

8. To establish an investment process that suits the objectives and risk profile of the investment strategies of a Hedge Fund, the Fund Manager of the Fund should:
   (a) identify the investment objectives of each investment strategy of the Fund;
   (b) identify and evaluate how risks associated with each investment strategy can be managed most effectively. This should involve assessing and evaluating the Fund Manager’s appetite for risks associated with each strategy and adopting adequate measures to deal with those risks including any stop loss measures as appropriate, depending on the markets in which they operate. This may lead to decisions to accept identified risks, or manage or mitigate those risks through various measures available to the Fund Manager, such as hedging and setting limits (see below);
   (c) identify any legal or self imposed constraints within which investment strategies of the Fund have to be implemented, taking into account investments or products involved, size and volume of the trades desired, nature and extent of leverage desired, geographic and market limitations etc.;
   (d) embed in the investment process the agreed measures (such as self imposed limitations) to address the identified risks, and document these measures and procedures clearly; and
   (e) communicate the investment process to all relevant persons involved in the execution of the investment strategy (such as employees and third party service providers such as fund administrators and execution brokers) in a clear and easily understandable manner.

9. The investment processes may develop over time as a result of factors such as improvement opportunities that become available and any structural or other changes in the operation of the Hedge Fund. The tolerance to risk may also change within the investment strategy. Therefore the investment process should contain sufficient flexibility to accommodate such changes, including sufficiently frequent reviews and updates to ensure its on-going suitability. Where changes do occur, it is vital that they are communicated to all relevant persons promptly and clearly.

Principle 3: A Fund Manager of a Hedge Fund should have systems and controls to mitigate trading related risks such as price overrides and failed trades

10. Hedge Funds are particularly vulnerable where price overrides and failed trades occur in the trading process (note - price overrides, sometimes called deviations, are rejections of a predetermined threshold for trading of a financial product or instrument under the Hedge Fund’s agreed policies and procedures). This is because investment strategies of Hedge Funds often involve hard to value and complex financial products and instruments and employ multiple third party service providers to implement those strategies,
which make it harder to assess the effect of such price overrides and failed trades on the Fund. This may expose the Hedge Fund to credit and market risks that are not easily addressed through its normal investment process and strategies.

11. To effectively manage and control the persons undertaking the dealing activities of a Hedge Fund, the Fund Manager should have in place a well defined and documented dealing procedure which:

(a) identifies who has the authority and regulatory approval to place investment deals for the Hedge Fund, including at third party service provider level such as execution brokers;

(b) establishes dealing procedures that document the process for transacting deals. This should include how the transactions are executed and what controls are in place to prevent a trader undertaking transactions outside his/her level of authority;

(c) ensures that those individuals undertaking dealing activities fully understand the dealing procedure, limitations to the transactions they can effect and, any changes to it as soon as they are made; and

(d) includes procedures for dealing with failed trades including who has the authority to re-trade.

12. To mitigate the opportunity for unauthorised price overrides, a Fund Manager’s trading procedures should include:

(a) at least at a high level, what steps are to be undertaken before a deal is placed in the particular market such as equity, fixed income, OTC derivative, FX etc;

(b) limits to a trader’s authority for dealing such as by reference to the investment type or size, geographic location, risk limits and counterparty limits and, where price overrides are permitted or when re-trades are to be effected, procedures that should be followed including effective monitoring;

(c) checks to be performed to ensure that the transactions have been executed correctly and within the relevant authority and any investment restrictions applicable to the Hedge Fund. These may include computer based or manual processes prior to execution (“pre trade compliance”);

(d) identification of persons with the responsibility for overseeing the investment dealing process and monitoring the quality of execution. If the Hedge Fund uses third party service providers, there should be appropriate monitoring and accountability built into the relationship with clear reporting lines between the third party service provider and the Fund Manager’s senior management;

(e) what processes are to be undertaken to deal with trading errors and trade failures, and their impact on the net asset value of the Units; and

(f) where appropriate, how segregation of roles between investment decision making, dealing and trade confirmation and bookings takes place.
Back office procedures

Principle 4: A Fund Manager of a Hedge Fund should have adequate back-office systems and controls to avoid backlogs in trade confirmations

13. Fund Managers of Hedge Funds as Authorised Firms have specific obligations to establish and maintain risk management systems and controls to identify, mitigate, control and monitor risks to their operations (see GEN Rule 5.3.4). A specific operational risk to which Hedge Funds are particularly sensitive, and which also has market-wide ramifications, relates to backlogs in trade confirmations. Backlogs are often attributed to late trade confirmations and non-notification of trade assignments and novations by relevant parties and are exacerbated by high volume trading that occurs in Hedge Funds. As Fund Managers of Hedge Funds often rely on multiple service providers, such as prime brokers, execution brokers, investment managers and fund administrators, backlogs in trade confirmations can make it even harder to ascertain and manage fund exposures to credit and market risks. Similarly, assignment of trades by Hedge Funds without prior approval or even notification of the relevant counterparties exposes the counterparties themselves to risk, thereby raising industry wide concerns.

14. To address such risks, a Fund Manager of a Hedge Fund should have back office procedures and controls to ensure that:

(a) all the key parties involved in the trading process, and the fund administrator, have adequate and up to date information on who has the authority to open and access prime broker or execution broker accounts, and their terms of operations;

(b) there is reconciliation of the trades, especially between different service providers such as prime brokers and execution brokers, through the maintenance of appropriate logs and other recording mechanisms and documentation. Reconciliation should be performed daily and if not, as often as reasonably practicable depending on the nature of the operations. It should be documented by an individual or a group independent of the entities that undertake trading and investment management function to ensure the integrity of the process;

(c) once a trade has been executed, all the relevant details of the trade are included in records that clearly capture key information such as the identity of the trader and the counterparty, the date, time and nature of the trade (such as buy, sell short), the relevant identifier (such as exchange symbol) and settlement details (such as the quantity, price and currency, the settlement date and commissions and other charges);

(d) all trades are confirmed with the counterparty, preferably on the same date as the trade, as this reduces the likelihood of problems such as failed clearing and settlements, or incorrect risk measurements of the portfolio. If a delay is anticipated in creating an appropriate confirmation reflecting the terms of a complex trade, the counterparty should be promptly notified of the expected delay;

(e) if the trade is to be allocated over different accounts, the method used for allocation by the trader is consistent with the overall policy adopted by the Fund Manager to ensure fair and timely allocation of trades;
(f) details of the trades are passed on to the relevant parties such as the prime broker (for settlement) and the fund administrator, preferably electronically, as this ensures immediacy and accuracy; and

(g) any failed trades are identified promptly, and there are documented procedures for dealing with failed trades, including the actions to be taken, notifications to the relevant parties such as the fund administrator, prime broker or custodian, an assessment of any consequences of the failed trade on the Fund’s portfolio and any remedial actions to mitigate those consequences and prevent recurrence.

15. To the extent possible, a Fund Manager of Hedge Funds should also undertake due diligence to ensure that counterparties themselves have similar systems and controls relating to trade confirmations.

Portfolio risk management

Principle 5: A Fund Manager of a Hedge Fund should have appropriate measures to identify and manage portfolio risks

16. While not unique to Hedge Funds, market, liquidity and counterparty risks can assume a special significance in the case of Hedge Funds. This is because their impact can easily be amplified well beyond the impact such risks normally have on a conventional Fund due to the use of leverage and derivatives.

Market risk:

17. Market risk encompasses all aspects of price related risks such as interest rate changes and other factors which affect prices such as volatility and non-linearity and correlation. The impact of these factors would depend on the nature and volume of the financial products or instruments used by the Fund. To manage these risks, a Fund Manager of a Hedge Fund should, at a minimum, have systems and procedures to:

(a) identify each major category of market risk that is likely to affect the Fund’s portfolio of investments;

(b) select a specific methodology to measure the impact of market risk on its portfolio that is suitable to the nature of the portfolio of the Fund; and

(c) apply consistently that methodology to measure the risk exposures of the portfolio within the pre-defined parameters, which will enable any breaches of the limits to be identified and corrected as soon as possible through measures (such as hedging or position correction) embedded in the investment process adopted by the Fund.

Liquidity risk:

18. Liquidity strains can stem from many sources such as potential damage to the Fund Manager’s reputation (resulting from events such as a rating downgrade or negative news about the Fund Manager or its associates), the nature of particular transactions (such as investments in OTC derivatives or stock-borrowing) and potential macroeconomic adjustment in markets in which investments are made. These can give rise to illiquidity of the Fund’s portfolio assets themselves, as well as the non-availability of funding from, or demand
for additional collateral by, expected sources of funding such as prime brokers. As a result, the Fund Manager’s ability to meet its operational needs such as redemptions, purchases and meeting margin calls can be seriously impaired.

19. To mitigate liquidity risk, a Fund Manager of a Hedge Fund should:
   (a) have redemption policies and procedures that correspond to the levels of liquidity of the underlying Fund assets and provide adequate flexibility to deal with any contingencies; and
   (b) ensure that the terms and conditions of the funding are clear and complied with at all times;
   (c) use reputable and reliable sources of funding, which should entail adequate due diligence and on-going monitoring of the sources of funding; and
   (d) identify available alternative sources of funding including, if possible, their availability under extreme adverse market conditions.

Counterparty or credit risk:

20. Often Hedge Funds trade on delivery against payment terms. Therefore, they have only limited exposure to counterparty risks. However, there may be other types of trades or periods during which Hedge Funds may have higher exposure to counterparty risks. To address such risks, the Fund Manager should have adequate due diligence procedures to assess the creditworthiness of counterparties where loss of solvency or default by the counterparty can have a significant impact on the Fund's operations. For example, if a prime broker is used as a source of stock lending and borrowing, it should be treated as a counterparty.

Leverage:

21. Hedge Funds often use leverage through borrowings and other measures such as the use of derivatives and short selling to enhance returns from a particular investment strategy. Such leverage can influence the rapidity and intensity with which market changes, exposures to counterparties and liquidity factors can impact on the value of the Fund’s portfolio. Therefore, a Fund Manager should put in place measures that will enable it to:
   (a) assess the degree to which the Fund’s portfolio can be adversely affected by the level of leverage used;
   (b) quickly modify or adjust its risk-based leverage in periods of stress or increased market risk;
   (c) monitor the level of exposures resulting from such leverage and its impact regularly. In most Hedge Funds, daily monitoring will be appropriate; and
   (d) where a Hedge Fund relies on different investment managers or prime brokers to execute discrete investment strategies, adopt systems and controls that are capable of assessing overall exposures and risks flowing from different investment strategies.
Derivatives related risks:

22. The continually evolving nature of derivatives and the various market and other conditions that affect their value and volatility present considerable valuation and liquidity risks for a Hedge Fund relying on extensive use of derivatives. This is particularly the case where OTC products are being used, as these are individually defined and significantly more complex.

23. To mitigate these risks, a Fund Manager of a Hedge Fund should:
   (a) when entering into derivatives contracts, ensure that it has, or has access to, adequate relevant expertise. Where derivatives used are particularly complex, the Fund Manager should have the ability to clearly understand the risks resulting from the use of such products or have access to relevant expertise through a reliable third party service provider, such as an investment manager or prime broker;
   (b) adopt suitable systems and controls to monitor specific risks arising from the use of particular derivatives and to ascertain whether the derivatives fit within the risk limits set for the Fund as part of the investment strategy;
   (c) understand the derivatives structures used, and also have ready access to sources of expertise where required, including adequate systems and controls to manage the risk of loss of access to such sources of expertise; and
   (d) have adequate procedures for the valuation of such contracts (see below).

24. A Fund Manager should also continue to enhance its risk measurement capabilities, with a view to keeping pace with advances in areas of model uncertainty associated with new and complex financial products.

Fund Valuations

Principle 6: A Fund Manager of a Hedge Fund should have adequate valuation policies and procedures to ensure integrity, accuracy and timeliness of the valuation process

25. Portfolio valuation is a particularly important aspect of Hedge Fund operations because Hedge Funds:
   (a) often invest in hard to value assets, such as distressed debt, OTC derivatives or in emerging markets. This makes it hard to find objective pricing sources or criteria and often results in valuations based on mark to model rather than mark to market valuations;
   (b) use substantial leverage, which amplifies the impact of any mis-pricing or valuation errors; and
   (c) permit performance-based remuneration, which exacerbates the potential for conflicts of interest to affect the valuation processes.

26. To address these risks, a Fund Manager of a Hedge Fund should have comprehensive and well documented valuation policies and procedures to ensure the integrity and relevance of the valuation process and to produce timely and accurate valuation of portfolio assets. For this purpose, a Fund
Manager of a Hedge Fund should ensure that:

(a) the Fund Property is subject to timely valuation, bearing in mind the nature of the Fund Property, market practice and investor expectations;

(b) the persons undertaking the valuation function have appropriate levels of competence and independence by:

   (i) setting out clearly the roles and responsibilities of the entities undertaking the valuation process;

   (ii) functionally separating the valuation function from the investment management functions of the Fund (which is a legal requirement under CIR 13.6.2). This may be achieved by a variety of ways, such as the delegation of the valuation function to a third party Fund Administrator or through other forms of segregation where both functions are undertaken by the same legal entity, such as Chinese Walls and independent reporting lines; and

   (iii) undertaking appropriate due diligence to ensure that the persons undertaking the valuation function have appropriate skills, knowledge and experience relevant to the type of financial instruments and their underlying assets that are to be valued, and the markets in which those assets are located or traded; and

(c) the valuation methodologies adopted are both appropriate and capable of bringing a high degree of objectivity to the valuation process. These will generally include inputs, models and the selection criteria for pricing and market data sources, as well as articulating a clear rationale for using the selected methodologies. As far as practicable, methodologies should provide for:

   (i) reliable, reputable and wherever possible, independent, pricing sources to be used;

   (ii) where illiquid assets are to be included in a portfolio, mechanisms to ensure a systematic, consistent and objective valuation process, such as obtaining the value from more than one expert and reaching an average;

   (iii) flexibility to accommodate any contingencies that can be anticipated, such as an asset not falling within the valuation methodology or any market change that may affect the use of the selected methodology; and

   (iv) consistent application of the methodology:

      A. across all classes of assets that share similar economic characteristics. For example, if the Hedge Fund has a number of investment strategies managed by different investment managers, the Fund Manager should ensure that methodologies employed for valuation are consistent to avoid valuation distortions between investment strategies; and

      B. by all persons involved in the valuation process, which entails adequate monitoring to ensure personnel involved in the valuation process adhere to the established procedures;
(d) there are adequate valuation reconciliation procedures, especially where there are different service providers, to ensure that any differences between them are swiftly resolved. This is particularly important as Hedge Funds use a variety of service providers such as prime brokers, custodians and Fund Administrators;

(e) there is a regular review, at least annually, to ensure compliance with, as well as continued relevance and appropriateness of, the methodologies adopted, including valuation assumptions and procedures. This can be undertaken by the person undertaking the independent oversight function (in the case of a Public Hedge Fund) or a valuation committee comprising individuals not involved in the valuation and investment management functions of the Fund. Those persons should have unrestricted access to the senior management of the Fund Manager for reporting purposes; and

(f) where price overrides are to occur, adequate procedures are in place to deal with such occurrences. These should include requirements for proper documentation of the reasons for price overrides. Those reasons should be reviewed by persons responsible for compliance on a timely basis and also as part of the review process referred to in (d).

Conflicts of interests such as side-letter arrangements

**Principle 7:** A Fund Manager of a Hedge Fund should not have arrangements under which any material benefits or concessions are provided to some investors where those would be unfair to any other investors in the Fund

27. Under the CIF regime, Fund Managers of Funds are required to treat Unitholders who hold interests of the same class equally and Unitholders of different classes (as between the classes) fairly, and to avoid conflicts of interests (see Article 22(2) of the Collective Investment Law and CIR Rule 8.3.1). Therefore, Fund Managers will need to consider carefully, before entering into any special arrangement under which material benefits or concessions are to be provided to some investors only (such as under side letter arrangements), whether that could lead to a breach of these requirements. Whether a particular arrangement would result in a breach of these requirements would always depend on the particular terms, conditions and circumstances of the individual arrangement.

28. We consider, for example, that arrangements that confer special monetary and economic benefits such as fee waivers on some investors only would generally amount to a breach of the Fund Manager’s obligations to treat customers fairly. If such benefits are conferred in return for any favours or benefits given to the Fund Manager or its related parties, this would be likely to also amount to a conflict of interest. In contrast, an arrangement which relates only to the provision of additional periodic reports relating to the performance of a Hedge Fund is unlikely to amount to a breach of these obligations in circumstances where the provision of additional reports is permitted under the constitution of the Fund, there is proper disclosure of the terms and conditions including any fees and charges applicable to such reports in the Prospectus and all investors are being offered an equal right to
obtain those reports (of course, such reporting cannot include any price sensitive information - see Principle 8). Fund Managers should also be aware that in some jurisdictions, side letter arrangements and benefits are treated more rigorously than this. Therefore, meeting these parameters may not necessarily be sufficient to comply with the relevant requirements in those jurisdictions, especially where side letter arrangements have an impact on investors there.

**Principle 8:** A Fund Manager of a Hedge Fund should have adequate systems and controls to deal with market sensitive information

29. The complexity of investment strategies and products involved, the close relations with counterparties and performance based remuneration of Fund Managers of Hedge Funds can create an environment where market abuses and manipulations can occur more readily. While the relevant conduct prohibitions and associated sanctions will continue to act as a strong deterrent against such abuses, Fund Managers of Hedge Funds should pay particular attention to the need to mitigate such risks through systems and controls which provide for:

(a) clear procedures for handling price and other market sensitive information by employees at the Fund Manager and third party service provider level. These should generally cover identification and adequate monitoring of the activities of individuals who are likely to handle such information such as traders;

(b) Chinese Walls to restrict information flows that could lead to insider dealing and other abuses. This is particularly important where the Fund Manager, or any third party service providers involved, serve multiple Funds;

(c) an accurate recording of any benefits or concessions received by traders, especially where late trading or other price overrides take place and involve a review of any irregularity of such benefits by the senior management as promptly as practicable (see also Principle 3); and

(d) the review of the adequacy of the above procedures by the senior management or, in the case of Public Hedge Funds, the persons providing oversight functions, at least annually.

**Fund of Hedge Funds Investments**

**Principle 9:** A Fund Manager of a Fund of Hedge Funds should not invest in an underlying Hedge Fund without appropriate due diligence.

30. A Fund of Hedge Funds is a Fund dedicated to investing in a number of other Hedge Funds. While best practice standards set out under preceding Principles apply equally to Fund Managers of Funds of Hedge Funds, it is critical that the Fund Manager of a Fund of Hedge Funds undertake appropriate due diligence on the underlying Hedge Funds to ensure that the profile of the underlying Hedge Funds fits within the risk and investment strategy of the Fund of Hedge Funds.

31. Some of the factors that should be taken into account by the Fund Manager of a Fund of Hedge Funds in its due diligence processes are:
(a) whether the underlying Hedge Fund and its a Fund Manager nd key service providers, especially those undertaking functions such as investment management, prime broking and valuation, are subject to a regulatory regime which provides for an adequate level of regulation. For example, whether the requirements relating to the underlying Hedge Fund require:

(i) adequate skills, expertise and other resources particularly at the Fund Manager or key service provider level;

(ii) an independent audit of that Fund, conducted in accordance with the accepted international audit standards;

(iii) arrangements for assets of that Fund to be held by a party subject to prudential supervision relating to the custody of assets;

(iv) detailed disclosure to investors (by prospectus or other information memorandum) of the investment strategies and policies as well as their associated risks, levels of leverage to be used by the Fund, fees and charges of the Fund and how they are calculated and levied, any potential market and liquidity risks to which the Fund may be exposed and valuation policies and procedures and any potential valuation problems that the Fund may face; and

(v) regular valuation of the Fund by reputable and reliable parties and the issue of valuation statements to investors; and

(b) whether the underlying Hedge Fund has investment policies and strategies and redemption mechanisms that suit the objectives, needs and circumstances of the target investor group of the Fund of Hedge Funds and are sufficiently transparent in that context.

32. The Fund Manager of a Fund of Hedge Funds should also undertake regular review of the underlying Funds to monitor the risk and suitability of each Fund in changing economic and market conditions.