

**AMF Position – Recommendation**  
**Funds of hedge funds management in France – DOC-2008-15**

**Reference text: Articles 313-54 and 318-3 of the AMF General Regulation**

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Since 2003<sup>1</sup>, France has had a regulatory framework for direct and indirect alternative asset management. Specifically, the regulations on the management of funds of hedge funds (FHF) enable the general public to gain access to the performance of alternative funds in a more secure framework than if they were to invest directly.

Funds of hedge funds management generally consists of three essential stages:

- selecting the underlying funds that may be targeted for investment;
- allocating the funds of funds to the most promising underlying funds and alternative investment strategies;
- monitoring risk.

The investment rules governing funds of hedge funds contain one key element: the diversification criteria restrict the investment universe to funds offering the most financial and legal security (eligibility criteria can be found in Article 422-95 of the AMF's General Regulation).

In 2007, after several years of observation, changes were made to the regulations based on proposals from the working group headed by Philippe Adhémar. The changes ensured continuity with previous texts, making sure that asset management companies take responsibility for enabling sufficient resources and for executing certain procedures in exchange for a more flexible regulatory framework.

The aim of this document is to report the main observations from the audit missions carried out in the area of funds of hedge funds management<sup>2</sup>.

**Except where recommendations are specifically identified, elements of policy included in this document are positions.**

<sup>1</sup> Decree no. 2003-1103 of 21 November 2003 amending Decree no. 89-623 of 6 September 1989 in implementation of Law no. 88-1201 of 23 December 1988 on collective investment undertakings.

<sup>2</sup> Audit missions conducted between April and November 2007.

## 1. Investment process

### 1.1. Selection

The selection of fund managers is crucial given the specific nature of this business:

- information about certain unregulated or barely regulated underlying funds (such as hedge funds or professional specialised investment funds) is not freely available;
- the strategies implemented are often complex and innovative, and may vary over time depending on the market conditions;
- the use of leverage is more common than in other types of management.

The selection phase enables the following elements to be assessed:

- the technical and human resources made available by the company that manages the underlying funds (size of teams, experience, profit-sharing incentives for managers);
- the type of management implemented and how the decision-making process is carried out (is there an ad hoc investment committee, for example?);
- the risk management system: this function is essential for asset management companies that use complex investment strategies and/or considerable amounts of leverage. Moreover, the underlying fund managers often measure risk to disclose their exposure and how it breaks down across the various sub-strategies. These managers often use different measurement methods<sup>3</sup>, which renders pointless any comparison between underlying funds unless these different methods are well understood;
- the internal control system and the quality of external controls: internal control, independent valuation auditors, quality and role of depositories, custodians, prime brokers and registrars.

It should be pointed out that the procedures must cover the entire selection phase (pre-selection, due diligence, decision-making structure) and be updated upon any operational changes. In this regard, Articles 313-1 and 318-4 of the AMF's General Regulations state that asset management companies shall establish and maintain appropriate operational procedures and measures to detect any risk of non-compliance with their professional obligations.

Reliance on the information provided by the underlying fund manager is a problem when it comes to the selection phase. This is especially true if said information is not subjected to quantitative consistency tests (comparing the underlying fund's previous volatility and the leverage estimated by the asset management company, analysing past results against stated performance drivers, etc.) or independent checks either by foreign regulatory authorities or by the entities involved in managing the underlying fund (registrar, depository/custodian, prime broker).

With regard to this last point, the report by the working group on funds of hedge funds (hereinafter the "Adhémar Report") highlighted the importance of due diligence on these key players in the alternative investment industry.

In addition, if an asset management company delegates part of the selection process (including the creation of the short list or the performance of certain due diligence):

- such delegation must not result in information asymmetry to the detriment of the asset management company, thereby giving the analysts at the delegated party a significant role in the management of the fund of funds. Should this happen, there would no longer be compliance with the autonomy principle laid down in Articles L. 214-9 and L. 214-24-44 of the French Monetary and Financial Code;

<sup>3</sup> Different ways of calculating value at risk (VaR) using various parameters (level of probability and period of time), implementation of gross or net position indicators or stress scenarios (including or excluding derivatives).

- work on identifying and preventing conflicts of interest must have been carried out prior to such delegation, particularly where the delegated parties are also investors in the funds or shareholders of the asset management company.

One of the main areas of due diligence is evaluating the risk control system of the target funds during the selection phase. This must cover both new and old investments and be updated regularly in order to keep track of the target funds, which may have totally changed their strategy (e.g. opportunist multistrategy vehicles).

In a broader sense, keeping up to date with due diligence is important. The monitoring work should therefore regularly cover all the elements analysed during the initial due diligence, thereby complying with Article L. 533-1 of the French Monetary and Financial Code and Articles 314-3 and 319-3 of the AMF's General Regulation<sup>4</sup>.

The initial due diligence phase also sees the first contact with the manager of the target fund. It is an opportunity for the asset management companies, before they invest, to establish their requirements in relation to transparency, risk management and the frequency of estimated and definitive value disclosure.

It has been observed that the balance of power between those doing the selecting and those being selected could be tipped against the asset management companies. Strengthened by their success and track record, certain underlying funds allocate investment capacity to applicant asset management companies on a case-by-case basis<sup>5</sup>. These underlying funds sometimes lay down their rules in advance, seek formal or informal assurances from the FHF manager about the stability of his/her investments over and above the gates<sup>6</sup> mentioned in the fund prospectus or require that he/she establish a fixed investment schedule in advance.

In this regard, the AMF insists that strict compliance with the due diligence process must prevail over the desire to invest in a particularly popular underlying hedge fund. Moreover, information about the performance of an underlying fund is more reliable if it is audited, can be tracked over time<sup>7</sup> and is accompanied by adequate risk management, which should, among other things, check that full due diligence has been carried out on the underlying fund.

Any shortfalls during the selection phase may be deemed by the AMF to be in breach of Article L. 533-1 of the French Monetary and Financial Code and Articles 314-3 and 319-3 of the AMF's General Regulation<sup>8</sup>.

The resources made available by the asset management company must be sufficient for the envisaged investment strategy. For example, the AMF has witnessed asset management companies investing only in funds that do not use derivatives or complex products (long/short equity, simple arbitrage, etc.) in order to avoid the uncertainty surrounding, or even the manipulation of, the net asset value of overly complex underlying funds.

## 1.2. Eligibility criteria in the selection process

In order to verify the eligibility of the underlying funds of the alternative funds of funds in terms of the criteria laid down in Article 422-95<sup>9</sup> of the AMF's General Regulation, most asset management companies ascribed particular importance to prospectus analysis. However, if the prospectus is not sufficient to make a final decision or if it goes against one of the criteria, certain asset management companies occasionally rely on statements from the underlying fund managers, with no independent verification. Although certain checks in the management of funds of hedge funds inevitably rely solely on statements provided by the

<sup>4</sup> These articles require the asset management company to perform its activities with diligence and professionalism, among other things.

<sup>5</sup> i.e. the permitted level of investment.

<sup>6</sup> Option for the underlying fund managers to restrict redemptions from said fund or temporarily close it.

<sup>7</sup> Being able to analyse the correlation of changes in the net asset value and the market is crucial.

<sup>8</sup> These articles require the asset management company to perform its activities with diligence and professionalism, among other things.

<sup>9</sup> Article 422-95 of the AMF's General Regulation applies to alternative funds of funds by reference from Article 422-250.

underlying fund managers, the AMF believes that checking eligibility criteria cannot be based on such statements alone.

For example, other more independent sources should be favoured in relation to asset segregation (currently the second eligibility criterion), perhaps by including this issue in the due diligence carried out on custodians and other entities involved in the process.

Lastly, the AMF has noticed that the prospectuses of underlying funds are often amended.

**Recommendation**

**The AMF recommends that amendments to underlying fund prospectuses require updated due diligence.**

**1.3. Allocation and monitoring of funds**

The AMF reiterates that the use of investment advisers must not compromise the autonomy of the asset management company, as per the principle laid down in Articles L. 214-9 and L. 214-24-44 of the French Monetary and Financial Code.

The AMF has noticed that target allocations are often determined in advance for different strategies (top-down approach). Given the complexity of the risk profiles of underlying funds, the convergence of the FHF towards the target exposure depends partly on taking into account the leverage of the underlying funds and partly on the asset management company checking the correct classification of the underlying fund as announced by the fund manager.

With regard to allocation, transferring underlying fund positions between portfolios is especially difficult because of the illiquid nature of the investments in question. As a result, such practice must be governed by procedure and by sufficient controls that ensure compliance with the interests of the investors in the two funds and prevention of conflicts of interest.

If the programme of activity is old, the asset management company must check whether the description in said programme of the characteristic elements of the investment process is still accurate. An update to this programme of activity may be required, as mentioned in Article L. 532-9-1 of the French Monetary and Financial Code. These changes may have to do with the partial delegation of the selection process, the use of an investment adviser in a role other than the one specified in the programme of activity or the delegated management of group funds.

**2. Managing risks**

**Recommendation**

**When the asset management company implements its risk management system, it should establish which indicators are to be subject to an overall limit, for example:**

- **leverage;**
- **underlying fund volatility;**
- **concentration;**
- **performance monitoring;**
- **VaR calculations, etc.**

In order to increase the responsiveness of asset management companies in a crisis, their risk monitoring framework must include an alert system that analyses the performance of the underlying funds as well as their risk parameters (volatility, exposure, leverage, etc.) and changes in their investment strategy.

Keeping tracks on the regularity of disclosure by the underlying fund manager can also alert the asset management companies to any problems.

If there is a significant change in the net asset value of the underlying fund, the asset management company should use consistency tests to verify the explanations provided by the underlying fund manager.

As well as the classic risks described above, one of the major FHF concerns for asset management companies is liquidity risk. Monitoring this risk entails both qualitative (such as the type of investors and stability of funds of funds) and quantitative (such as the asset/liability balance, the alignment of certain fund liquidity clauses to those of the target underlying funds, and the limit to control over an underlying fund) elements.

As stated in Articles 411-123 and 422-81 sub-paragraph 1 of the AMF's General Regulation, these frameworks aim to ensure that the "*net asset value shall be established and published with a frequency appropriate to the nature of the financial instruments, contracts, securities and deposits held by the collective investment scheme*[or certain alternative investment funds<sup>10</sup>]".

With regard to monitoring liquidity risk to implement stress scenarios for the liquidity of underlying funds, it is possible to take into account the activation of gates or other clauses restricting the possibilities of exiting these funds, such as a maximum redemption amount on calculation of the net asset value.

Moreover, any imbalance between assets and liabilities may create uncertainty during calculation of the net asset value of the fund of funds. If the fund of fund's net asset value is calculated more often than those of its underlying funds, these latter NAVs may be old. Particular vigilance around potential market-timing transactions is required in such a case.

The use of estimated values for underlying funds must be mentioned in the prospectus of the collective investment scheme (CIS) or alternative investment fund (AIF) pursuant to Articles 411-25 and 421-28 sub-paragraph 2 of the AMF's General Regulation, which state that the financial instruments, derivatives, securities and deposits listed as the assets of a CIS or held by the CIS, or the assets making up the portfolio of the AIF, are valued every day that the net asset value is determined, under the conditions set out in the prospectus.

It should be remembered that these estimates are intrinsically less reliable and are not "official" or "final" NAVs upon which the fund's usual subscriptions and redemptions can be based. As a result, measures must be in place to increase the reliability of these estimates if they are to be used.

### **3. Investor information and marketing**

Beyond the "know your customer" measures arising from the Markets in Financial Instruments Directive (MiFID), the allotment letter must make the investor aware of the provisions of Article L. 214-144 sub-paragraph 3 of the Monetary and Financial Code, which state that the investor must be informed of the investment rules specific to general-purpose professional funds.

<sup>10</sup> These include general-purpose investment funds, general-purpose professional funds and alternative funds of funds.



#### **4. Internal audit**

The monitoring of the FHF activity should include specific controls of areas that require asset management companies to be particularly vigilant, such as the selection process, risk management and the monitoring of order processing.

For example, in addition to the above, in many cases the processing of orders involving underlying funds requires a written confirmation (or even a contract) to be drawn up, which may delay the execution of the subscription or redemption orders. Companies should also pay particular attention to controls of the legal circuit and checks of compliance with Article 314-75 of the AMF's General Regulation, which states that the time frame for executing orders, from receipt to transmission, must be shortened and audited.