AUTORITÉ
DES MARCHÉS FINANCIERS

Report of the working group chaired by Philippe Adhémar on the assessment of the French regulatory framework for funds of hedge funds and on possible areas of improvement

18 September 2007

Contents

[1] Hong Kong Securities and Futures Commission.

EXECUTIVE SUMMARY

The recommendations of the report of the working group on funds of hedge funds (FoHFs) adopt a **principles-based approach** predicated on the special programme of operations for management companies carrying on a FoHF business. The quid pro quo of this principles-based approach is a more formal framework giving management companies greater responsibility for performing appropriate due diligence and justifying their investment decisions on an ex post basis.

I. The report's main recommendation is to replace the 13 regulatory criteria for eligibility of underlying funds with a set of general principles

The purpose of this recommendation is to replace the 13 criteria in the AMF General Regulation by general principles concerning crucial aspects of the legal regime, the functioning and the organisation of underlying hedge funds, namely:

- that the rights attached to the instruments in which the assets of the fund are invested exist and can be enforced at all times;
- that the assets of the underlying fund are held separately from those of the custodian and the agent;
- that the shares or units held by the fund are valued appropriately at least once a month and that there is a legally binding requirement for the financial statements to be audited at least annually.

The group recommends that these principles should be respected before and after investing in a hedge fund.

II. Recommendations on technical changes

II.1. Authorise funds of FoHFs on three conditions

- full transparency on fees and expenses;
- any fees rebated between the top-level fund and the underlying funds must be retained by the top-level fund;
- the underlying funds of funds must be either French funds approved by the AMF (ARIA III or ARIA I) or foreign funds authorised for sale in France.

II.2. Authorise ARIA III funds to invest in hedge fund derivatives on two conditions

- the management company can demonstrate to the regulator that it is able to value such derivatives accurately and independently on an ongoing basis;
- the management company must explain in the ARIA III prospectus how the use of this type of derivative will affect the risk profile of its fund, in particular when the derivative is highly leveraged.

II.3. Authorise the introduction of redemption gates

The FoHF manager would be permitted to implement a gate provision under its own responsibility, providing it respects certain conditions (investor information, exceptional use of the provision, responsibility of the management company).

II.4. Ensure effective external control of the due diligence conducted by FoHF management companies

The aim is to stipulate the management company's commitments to the depositary and to underscore the role of the statutory auditor.

III. Recommendations aimed at maintaining or enforcing existing rules

III.1. Maintain the principle of a minimum diversification requirement for underlying funds

The principle of minimum diversification of underlying funds is maintained and the minimum limit is lowered from 16 funds to 10.

III.2. Ensure that cost transparency requirements are in line with those for conventional funds of funds:

The aim is to make final investors aware of the cost to the FoHF manager of selecting and monitoring underlying funds and to inform them of overall expenses (via the total expense ratio), including all the expenses relating to the underlying hedge funds.

III.3. Communicate more clearly about the characteristics of French FoHFs

The fund prospectus must give a clearer explanation about the type of risk indicators used by the manager in its selection process and about the risk/return profile, with a view to raising the standard of information supplied to retail investors about the characteristics of French FoHFs.

III .4. Maintain the current minimum investment amounts for French FoHFs, while ensuring the funds are marketed appropriately

The current entry threshold of EUR 10,000 should be maintained for non-qualified investors wishing to invest in an ARIA III fund that does not provide a capital guarantee. It is also important to stress the importance of due diligence on the part of the distributor so as to prevent inappropriate sales or mis-selling to unsophisticated retail investors.

III.5. Define a secure framework for appropriate due diligence by FoHF managers

With regard to the appropriate due diligence procedures that the FoHF management company must carry out to prevent fraud risk and operational risk, the group recommends that:

- the company should have **a documented, traceable procedure for selecting hedge funds**, based on a qualitative and quantitative analysis of the fund's characteristics and the associated risks;
- the procedure should be implemented using suitable **human and technical resources** via **a collective decision-making process**;
- the company must have the **resources, procedures and organisational structure** needed to deal with any anomalies identified when monitoring the selected hedge funds and to take the necessary corrective action, leaving a proper audit trail.

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These recommendations could serve as guidelines for the AMF's position in international discussions on FoHFs and, in particular, for the creation of a European vehicle for funds of hedge funds.

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INTRODUCTION

The hedge fund industry has expanded remarkably in recent years, with strong growth in assets under management, particularly since the stock market bubble burst in the early 2000s.

Worldwide, an estimated 8,000 hedge funds now manage assets of more than USD 1,500 billion[2]. This upsurge partly reflects hedge funds' ability to earn attractive returns at a time when global savings were invested mainly in assets tied to traditional indices yielding modest or negative returns.

An increasing number of investors have used funds of hedge funds[3] (FoHFs) to gain access to alternative investment strategies. FoHFs, too, have been hugely successful over the past few years: the 3,000 funds operating worldwide now manage assets estimated at between USD 700 billion and USD 1 trillion[4], compared with less than USD 50 billion at the end of 1999. On this evidence, FoHFs are easily the main channel through which hedge funds are distributed to final investors.

Hedge funds were reserved until recently for qualified or wealthy investors, but they have since broadened their client base. Wholesale (or institutional) investors followed by retail investors have turned in greater numbers to alternative investment strategies, mainly through FoHFs, which can be accessed under increasingly flexible conditions.

This is particularly the case in France, where FoHFs are available within a regulated framework to any investor willing to invest at least EUR 10,000, provided they have been duly advised before making the investment.

What are funds of hedge funds? In France, which collective investment schemes are involved?

With a FoHF, a management company selects a number of underlying funds that use one or more alternative investment strategies and includes them in a portfolio it manages either through collective investment schemes or under a discretionary mandate (see inset 1).

In return for a fee, these FoHFs provide a variety of services to their investors, including access to alternative investment strategies, management of operational risk in the underlying hedge fund, and risk pooling and diversification, which they generally achieve by investing in more than ten hedge funds.

In France, FoHFs developed mainly within the supervisory framework defined by the Commission des opérations de bourse (COB) in a decision issued in April 2003 after lengthy consultation with industry professionals[5] and subsequently incorporated into the Financial Security Act[6].

Inset 1 clarifies the often-confused roles of hedge funds and private equity, and describes the different structures regulated by the Autorité des marchés financiers (AMF) that are authorised to implement alternative investment strategies. It also indicates the specific financial products considered by the

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[2] Source: Hedge Fund Research (HFR).

[3] French has several terms to designate funds of alternative investment funds, which are often translated literally into English. They include "funds of alternative funds", "funds of alternative management funds", and "funds of alternative multi-management funds". The terms all designate collective investment schemes or funds investing in units or shares of funds implementing alternative investment strategies. For simplicity, the term "fund of hedge funds", abbreviated where necessary to FoHF, has been used throughout this report.

[4] Based on either HFR or Barclays estimates for July 2007.

[5] See COB April 2003 monthly review (No. 378).

[6] Financial Security Act 2003-706 of 1 August 2003, creating *OPCVM à règles d'investissement allégées* or collective investment schemes with streamlined investment rules (see articles L. 214-35 and L.214-35-1 of the Monetary and Financial Code) and *OPCVM contractuels*, or contractual schemes (see articles L. 214-35-2 to L. 214-35-6 of the Monetary and Financial Code).

working group, namely funds of hedge funds classified by the AMF as *OPCVM ARIA de fonds alternatifs*[7] (also known as ARIA III funds).

Inset 1: Hedge funds and funds of hedge funds

1. Definition of alternative investing and hedge funds

There is no internationally accepted definition of alternative investing. In practice, however, the term refers to asset management strategies seeking returns that are not correlated with the market. The vehicle used for implementing alternative investment strategies is commonly known as a hedge fund.

Because of the lack of a legal or formal definition, the International Organization of Securities Commissions (IOSCO) identified five key characteristics that are often, but not always, associated with these funds:

- diversification and marketability restrictions do not apply, in contrast to conventional investment funds, meaning that hedge funds can invest in illiquid and/or complex assets;

- derivatives and/or short-selling techniques can be used extensively;

- hedge funds can use leverage, obtaining financing from prime brokers;

- substantial performance fees, typically 20% of the fund's performance, are paid to the hedge fund manager in addition to an annual management fee of around 2%;

- investors are subject to redemption conditions, often limiting the amount and timing of redemptions after a lock-up[8] period of generally 2 to 3 years.

Hedge funds use a diverse range of strategies, which can include:

- long/short strategies, which consist in taking buy (long) and sell (short) positions in assets from the same industry or geographic area;

- arbitrage, especially convertible arbitrage, which consists in buying undervalued convertible bonds on the market while shorting the underlying shares;

- investing in distressed securities to take advantage of financial difficulties experienced by companies (bankruptcy or financial reorganisation);

- event-driven strategies, which capitalise on opportunities arising from corporate events such as mergers or acquisitions;

- managed futures strategies, where the fund is managed by systematically taking positions in all markets through futures;

- global macro strategies, designed to take advantage of changes in economic indicators.

2. Scope of private equity and hedge fund activities

Private equity is defined as investing in a company in order to finance its start-up or development, or subsequent transfer or sale.
A private equity investment is primarily financial, but may also be strategic (e.g. contribution of a business contact network or management expertise).
Private equity can usually take two forms:

- development capital, which finances the creation and expansion of a company,

[7] An ARIA fund operates under streamlined investment rules.
[8] Lock-ups prevent investors from redeeming their units during a specific period.

- buy-out capital, i.e. investments to purchase existing companies.

In France, venture capital funds (*fonds commun de placement à risques* – FCPR) are one of the most common private equity vehicles. An FCPR is a fund with at least 50% of its assets invested in securities not admitted to trading on a regulated market in France or elsewhere (unlisted companies) or in non-voting securities (*titres participatifs*). FCPRs may be authorised to operate under either standard or streamlined investment rules.

The working group did not address private equity or FCPRs.

3. Current features of French collective investment schemes implementing a FoHF strategy

All collective investment schemes organised under French law are authorised to invest in hedge funds. However, when French funds have more than 10% of their assets exposed to in units or shares of foreign investment funds, ARIA funds, contractual funds or FCIMT managed futures funds[9], they must be registered by the AMF in the *OPCVM de fonds alternatifs* (funds of hedge funds) category.

Funds in this category are collective investment schemes with exposure of more than 10% to shares or units of foreign investment funds or French funds following alternative investment strategies. The fund is still classified as a *fonds de fonds* (fund of funds).

Funds classified as *OPCVM de fonds alternatifs* can be organised as:

- ***OPCVM ARIA de fonds alternatifs*** (ARIA fund of hedge funds): characterised by an initial investment of at least €10,000 for non-qualified investors if the fund provides no capital guarantee, monthly (or more frequent) net asset value calculations, risk diversification rules similar to those applicable to general-purpose funds, and a maximum leverage of 2 (i.e. 100% of the fund's assets). This type of fund, also known as ARIA III, was the central focus of the working group's discussions;

- ***OPCVM ARIA sans effet de levier*** (unleveraged ARIA fund), characterised by an initial investment of at least €125,000 for non-qualified investors, monthly (or more frequent) net asset value calculations, certain exemptions from the risk diversification rules applicable to general-purpose funds (e.g. exposure to French or foreign hedge funds can equal up to 20% of assets), and leverage of 2 as for general-purpose funds (i.e. 100% of the fund's assets);

- ***OPCVM contractuel*** (contractual fund), characterised by an initial investment of at least €250,000 for non-qualified investors, quarterly (or more frequent) net asset value calculations, and investment and debt policies set forth in the constitutive rules.

[9] FCIMTs are funds investing in financial and commodity futures. All FCIMTs are authorised to operate under standard investment rules.

Aim of the group's work: combining a backward-looking and a forward-looking approach

The study carried out by the AMF and its working group combined a backward-looking with a forward-looking approach.

The objective was firstly to evaluate, together with all interested market participants, the current regulatory framework drawn up in 2003 and implemented in 2004; and secondly to identify as effectively as possible the economic and regulatory outlook for a sector that has recently come under increasing scrutiny by investors, the European authorities and international regulators.

Drawing on the assessment carried out with industry professionals, investors and academics, the AMF wants to stress the merits of its own regulatory model and underlying standards in the international discussions where it will play an active part.

Two-pronged approach to assessment

The assessment of the regulatory framework for French FoHFs relied chiefly on:

- the discussions and findings of the working group made up of market practitioners, investor representatives, academics and industry experts[10]. The group was chaired by Philippe Adhémar, AMF Board member and Chairman of the Consultative Commission on Individual and Collective Asset Management.
  The group's remit was to diagnose in detail the strengths and weaknesses of the current regulatory framework and, where appropriate, to make proposals for changing it. The working group met seven times between 4 April 2007 and 18 July 2007. To obtain additional information, it conducted a series of interviews with experts from European regulators, a representative from the European Commission and a consultant[11];

- the responses to a consultation targeting key stakeholders, with a view to canvassing their opinions on the current regulatory framework and ways of improving it. This consultation enabled the AMF to keep the markets informed of its goals while compiling views on the ways in which the regulatory framework for FoHFs could be adapted.

This report therefore discusses the conclusions reached by the working group after considering the findings of the AMF consultation[12].

A four-part report recommending significant changes to the current framework for FoHFs and management companies

The first part of the report describes the state of the funds of hedge funds market in France, the challenges it faces and the conditions in which it can offer opportunities to investors.

The second part takes an in-depth look at the five reasons prompting the AMF to launch its consultation and bring stakeholders together to analyse these issues from both a backward-looking and forward-looking standpoint.

The third and fourth parts recommend changes to the regulatory framework for FoHFs. Taking the example of well-organised management companies conducting appropriate due diligence, a number of new ideas are put forward to adapt the regulations applicable to funds of hedge funds, with a view to bringing them into line with the international standards currently being drafted.

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[10] See Appendix 1 for a list of working group members.

[11] See Appendix 2 for a list of people interviewed by the working group.

[12] See Appendix 5 for an overview of the targeted consultation launched by the AMF on the assessment of its regulatory framework for funds of hedge funds in France, and on possible areas of improvement.

I. Fund of hedge fund investing in France: a growing market where retail and wholesale investors can access alternative investment strategies within a regulated framework

I.1. Retail investors in Europe can already access alternative investment techniques through an array of financial vehicles

Retail and wholesale investors in Europe can already gain exposure to hedge fund strategies. Retail investors can acquire more or less direct exposure by acquiring exchange-traded certificates, listed hedge funds or certain unit-linked life insurance policies. They can do this either as part of individual asset management arrangements or through funds of hedge funds (FoHFs).

Feedback on this issue to the AMF consultation highlighted competitive distortions between different financial vehicles employing similar techniques. These distortions place FoHF products at a disadvantage.

For example, hedge fund structured products can be authorised for sale in France, but a French FoHF cannot invest in a derivative with an embedded option if the underlying is a hedge fund.

It was also noted that the recent introduction of listed closed-end funds to European regulated markets gives all French investors access to investment vehicles with hedge fund exposure, based on the provisions of the Prospectus Directive.

The working group observed that retail investors in Europe can already use a variety of investment vehicles to access hedge fund investment strategies without any particular investment restrictions.

I.2. FoHF products in France: an AMF-regulated framework gives retail investors access to hedge fund investment strategies

FoHF investing has developed in France within a framework of rules covering the authorisation, operation and marketing of collective investment schemes (CIS) that invest in hedge funds.

These CIS have made alternative investing available to a wider population through a variety of French and foreign funds that apply this type of approach[13].

The framework for FoHFs sets down a number of requirements:

- management companies must have an AMF-approved special programme of operations;
- underlying investment funds must comply with 13 eligibility criteria[14], listed in Article 411-34[15] of the AMF General Regulation;
- the CIS must comply with the maximum leverage allowed under the regulations (two in the case of ARIA III funds);
- net asset value (NAV) should be calculated at least every month. NAV calculation frequency should reflect the liquidity of the underlying funds in which the CIS is invested;

[13] These schemes can have exposure to different fund categories, including common funds (*fonds communs de placement* – FCPs), open-ended investment companies (*sociétés d'investissement à capital variable* – SICAVs) and trusts.

[14] In the case of contractual fund, the management company's programme of operations must detail any eligibility criteria that underlying funds are allowed to waive.

[15] See Annex 3 for the 13 criteria in Article 411-34 of the AMF General Regulation.

- ARIA III funds must comply with the same risk diversification rules as those applicable to general-purpose CIS;

- there must be minimum investment requirement for non-qualified investors investing in ARIAs with streamlined investment rules or contractual funds.

French FoHFs are open to any investor provided he or she can invest a minimum of €10,000 – one of the lowest levels in Europe. By comparison, Spain and Germany do not require a minimum investment, in Portugal the minimum is €15,000, and the thresholds are much higher elsewhere, rising to €500,000 in Italy[16].

The UK is planning to introduce an onshore regime for FoHFs with no minimum investment threshold[17].

The working group noted that, as in France, regulators across Europe have already introduced or are introducing regimes for retail FoHFs. As part of this process, they are lowering the minimum investment thresholds for FoHFs to reflect the fact that these funds are now being made available to a much wider constituency of retail clients.

I.3. The French market is fast expanding. Assets under management, though, are still modest and remain concentrated with a few participants

I.3.1 The French market is expanding quickly. Assets under management, though, are still modest

- According to the AMF's calculations, at 31 December 2006, 239 funds in France were classified as *OPCVM de fonds alernatifs* (funds of hedge funds), with €23 billion under management.

Of these, 141 were organised as ARIA III FoHFs. These had total assets under management of €18 billion, evidence that FoHFs are a preferred vehicle for distributing alternative investment techniques in France within a regulated framework.

- Total assets in FoHFs in France remain highly concentrated. The industry's largest FoHF has more than €3.2 billion under management and the second-largest more than €960 million. The top two funds therefore account for more than 20% of total assets in French FoHFs and the top five funds hold more than one-third of the total.

- Investments in these funds are rising at a sustained pace. The total assets managed by French FoHFs stood at just €8 billion or so at 31 December 2005. In the first quarter of 2007, subscriptions increased by more than 13%[18].

Despite this sustained growth, the working group found that total assets managed by regulated alternative investment vehicles still accounted for a disappointing 1% or so of the total assets of AMF-authorised funds[19].

The group attributes this relatively poor marketplace performance to inappropriate regulation of institutions such as mutual insurance companies, pension funds and insurers, rather than to intrinsic problems in France's regulations for alternative investing. It feels that investments in alternative products are being impeded by regulatory constraints that are not necessarily warranted from the

[16] Cf. Annex 4 on investment thresholds in Europe.
[17] Cf. Section II.4. 3. of this report.
[18] Source: Astérias.
[19] Source: Astérias.

perspective of regulating wholesale investors. The group reiterates the need for a strong domestic market as a springboard for French companies to expand abroad.

The working group calls for changes to the regulations for wholesale investors, like mutual insurance companies, pension funds and insurers, to allow them to invest more in alternative vehicles.

In the group's view, this report, and particularly the debate that it will generate within the French financial community, should impress the importance of this issue on the authorities that are responsible for supervising wholesale investors. The group also calls on the AMF to take steps to build awareness among these supervisors.

I.3.2. Total assets under management in FoHFs are still concentrated with a handful of participants

Of the 500 management companies authorised by the AMF, 73 currently have AMF-approved special programmes of operations in the area of FoHF investing[20].

However, total assets are still heavily concentrated with a few participants: the top two management companies have more than 40% of total assets in FoHFs and the top five account for over 60%.

As major consumers of financial services, particularly investment advice, FoHF management companies have had an appreciable effect on the business and profits of financial intermediaries in the French finance industry[21].

I.4. Provided they are marketed with the appropriate disclosures, FoHFs are a way for investors to diversify their financial portfolios

- The working group organised hearings to gain a better idea of the benefits of FoHFs for investors in general and retail investors in particular. The European Commission representative made it plain that this question was a concern for the Commission, which was mulling future action in this area.

To be successful, alternative investing relies on a mix of three performance drivers, calibrated to the strategy being applied:

- the ability of managers to exploit market inefficiencies, particularly mis-pricing within a given asset class;
- portfolio exposure to risk factors rarely seen in conventional (i.e. long only) asset management, like liquidity risk and volatility;
- the ability of the same managers to judiciously adjust their exposure to different asset classes depending on market conditions (known as "variable beta").

The drivers' effects are intensified because these fund managers are not bound by many of the regulatory and other investment restrictions placed on conventional management and because returns are extremely attractive. The working group therefore agreed that FoHF investing has a special role to play, particularly as a means for retail and wholesale investors to diversify their financial assets.

[20] Compared with 67 on 31 December 2005 and 60 on 31 December 2004.
[21] Cf. the AFEI's response to the AMF's consultation on evaluating France's framework for FoHFs and proposing potential avenues of improvement.

- To support this assessment, one working group member studied the past performance of FoHF products and the effect on the risk/return relationship of introducing them to investor portfolios[22]. Naturally, these results must be treated with care because past performance is no guarantee of future returns.

The scope of the analysis extended beyond ARIA III funds to look at FoHFs worldwide between January 1990 and February 2007. FoHF products were shown to have significantly outperformed other asset classes. The return on FoHFs was mainly correlated with equity returns, and was far more weakly correlated with returns on bonds and cash. That said, the correlation of FoHF and equity returns did vary over time. It declined in 2000-2002 when equity prices fell steeply, before strengthening with the rebound from 2003 onwards. In other words, hedge funds and, by extension, FoHFs, have a track-record of judiciously adjusting their exposure to equity markets[23].

Annex 6 of this report assesses the impact of introducing FoHF products into a financial portfolio. The initial portfolio is assumed to be equally weighted between equities, bonds and cash. FoHFs are added gradually, increasing their share from zero to 20% of the portfolio's total assets. The remainder of the portfolio continues to be equally weighted between the three standard asset classes: cash, bonds and equities.

Adding FoHFs does appear to enhance overall portfolio performance, potentially boosting the average return while simultaneously reducing risk through diversification. This can lead to a considerably improved risk/return trade-off, as shown by the increase in the Sharpe ratio[24].

A similar simulation was carried out for ARIA III funds over a shorter period: August 2003 to the present. An index of ARIA III funds was prepared for the purposes of the simulation. The findings were similar. Once again, it transpired that introducing hedge funds can help to drastically reduce risk. Overall, such a move can improve a portfolio's risk/return profile, as evidenced in higher Sharpe ratios.

- These results illustrate the potential cost of preventing an entire group of investors from accessing these products.

Even so, the working group insisted that investors must have proper understanding of the specific risks that a FoHF investment entails. The members of the group noted that the conventional volatility indicator, and the Sharpe ratio derived from this, fail to provide a properly balanced comparison of the returns earned by FoHFs and other asset classes, particularly equities. Although more advanced statistical methods can be used to mitigate these limitations, they are less widely used and cannot claim to offer an entirely satisfactory response to hedge fund-specific risks.

For one thing, hedge funds are often illiquid investments. An FoHF approach reduces illiquidity risk, without eliminating it altogether.

Furthermore, hedge funds run into problems in terms of valuing their illiquid or complex assets that equities, for example, encounter far less frequently. For some strategies, marking to model rather than to market may create a downward bias in estimated performance volatility.

Additionally, even when correctly calculated, the Sharpe ratio does not offer a proper comparison of the risk/return profiles of different investments. Long-term investors are also interested in the magnitude of mean-reverting forces, i.e. the ability of investments to rebound after a negative spell. And regardless of their investing horizon, investors also have to consider the distribution of returns at a given volatility. They will generally prefer a product with relatively symmetrical gains and losses, i.e. those that are normally distributed, over a product offering small, regular gains that are occasionally offset by a large loss.

[22] Cf. Annex 6 of the report, entitled "Taking Stock of ARIA Funds".
[23] The term "alternative beta" is used to describe the ability of hedge funds to judiciously adjust their market exposure.
[24] The Sharpe ratio measures the excess return over the risk-free rate divided by risk (measured by the standard deviation of returns). It gauges the manager's ability to beat the return on a risk-free investment with the lowest possible volatility.

The appropriate mix of alternative products and equities in an optimal diversified portfolio thus remains open to question. The statistical data gathered for this report offer no conclusive proof that FoHFs can deliver the returns of an equity and the risk of a bond. Accordingly, the particular risks entailed by such an investment must be clearly pointed out when selling FoHFs.

- Some group members recommended that the Paris financial community devise and publish an ARIA III index to provide retail investors with an objective indicator to measure the performance of this kind of fund. These investors would then be able to weigh the benefits of introducing a FoHF product to diversify their financial portfolios.

Investors will now have the option of introducing FoHF products to diversify their financial portfolios. However, they must have a proper understanding of the specific risks associated with FoHF investments, which stem from the illiquidity and unusual risk/return characteristics of some alternative strategies.

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France introduced a regulatory framework for FoHFs in 2003. Although total assets under management are still disappointingly low, the framework has proved broadly satisfactory, delivering appreciable value added to investors by helping them diversify their portfolios.

However, the regulator has joined forces with industry stakeholders to assess and improve this framework. A number of reasons prompted this decision to take action.

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II. Five reasons to act

II.1. The need to evaluate: ex post assessment makes for good regulations

In 2006, the AMF initiated its Better Regulation approach, which seeks to balance investor protection and the economic and financial growth of the French finance industry, and also to identify and implement measures that will improve operational efficiency.

The process is moving forward in stages. An outline paper based on the initial consultation was prepared in summer 2006 and published as part of the AMF's annual one-day conference on 30 November 2006[25].

Based on the lessons of the consultation, the AMF recommended "increasing ex post controls and making professionals more accountable, instead of conducting systematic pre-vetting reviews"[26]. (…) "Pre-filing reviews could thus be streamlined. In return, more attention would be paid to due diligence by responsible parties during ex post controls."

The group analysed this solution carefully when looking at ways of improving the regulatory framework for FoHFs.

Moreover, the group based its course of action on the methodological approach chosen by the AMF in this regard, i.e. "wherever necessary, these efforts will be followed or accompanied by industry initiatives conducted via mixed groups comprising representatives of investors, listed companies and professionals. Work is scheduled to begin in early 2007"[27].

The working group followed the AMF's Better Regulation approach when evaluating the regulatory framework for FoHFs in first-half 2007.

II.2. Lessons to be learned from hedge fund failures, particularly the Amaranth crisis of end-2006

Amaranth, a hedge fund, ran into serious difficulties at the end of 2006. The lessons that the AMF learned from this situation, particularly in terms of the effects on ARIA III funds, played an important part in informing the working group's deliberations.

Inset 2: Lessons learned by the AMF from the impact of the failure of Amaranth, a US hedge fund, on French FoHF companies and an examination of due diligence by fund managers

Background

Amaranth, a US fund not regulated by the AMF, started out as a multi-strategy vehicle. However, it gradually concentrated its positions on the energy market, which then moved against it. This situation, amid turbulent market conditions that prevented positions from being unwound at normal prices (Amaranth's positions were concentrated and illiquid), brought the fund to the brink of collapse in September 2006, with the press reporting losses of over USD 6 billion.

[25] Cf. page 9 of AMF paper, "Promoting Better Regulation: Outcome of the consultation – The AMF's commitments", November 2006.
[26] Ibid., page 13.
[27] "The challenges of the new regulatory environment: how is the French financial community adapting?", Closing remarks by Michael Prada, AMF Chairman, at the AMF's annual one-day conference in 2006 (30 November 2006).

Impact on French asset management

Four French management companies had selected Amaranth. Fifteen or so French funds were thus affected, including five with direct investments in Amaranth. A private vehicle posted the steepest fall of all the affected funds, losing 3.40%. The largest decline recorded by a retail fund was 1.45%. Three foreign funds managed by French management companies were also affected.

The French regulatory framework for FoHFs enables management companies to limit the legal and operational risks associated with the inherent structure of these funds, which are offshore entities managed by lightly regulated companies. It also helps them to assess the risks associated with the strategies pursued by these funds.

Amaranth demonstrated the robustness of the French system. Portfolio diversification greatly mitigated the impact of Amaranth's losses on the affected funds of funds. The initial selection process enabled management companies to identify fund investment approaches and led them to focus on multi-strategy funds. Subsequent monitoring allowed investor companies to spot the portfolio's energy-heavy concentration, prompting some of them to scale back their positions.

The AMF initially believed that its investigations of end-2006 showed that the Amaranth failure had not exposed any major problems in the monitoring and analytical processes used by management companies in France.

However, an examination of due diligence by FoHF managers revealed that they could have paid greater attention to the following points:

- the broad latitude enjoyed by some multi-strategy hedge funds in terms of strategy selection may materially alter the risk profile of the fund. This risk must be assessed and, if necessary, compared against the fund's liquidity;

- a hedge-fund monitoring programme should identify substantive changes in fund strategies. It must therefore include updates to the due diligence performed for the initial investment, plus a review on whether to exit the fund. This requirement must never be overlooked, even if the fund performs strongly.

In the working group's view, the Amaranth failure holds the following lessons for the French finance industry and for French FoHFs:

- the risk diversification rule for ARIA III funds was a key safety feature of the French regulatory system;

- Amaranth had to contend with losses stemming from bad trading positions on the natural gas market and from uncontrolled liquidity risk. Failure became inevitable once the fund was unable to meet redemption requests at a time when prime brokers had begun making large margin calls and everyone involved had a fairly clear idea about the fund's loss-making positions. As a result, the liquidity risk of the underlying hedge fund, though never easy to measure in practice, was one of the main risks that FoHF managers had to identify and assess;

- the Amaranth case shows how important it is for FoHF managers to monitor underlying hedge funds over time, particularly if a multi-strategy fund becomes a single-strategy fund. A change in the volatility of the underlying fund's performance may be a useful signal in this regard;

- the FoHF manager's due diligence must cover the ability of the hedge fund manager to make discretionary decisions about strategy. If the prospectus gives broad latitude to the hedge fund manager, the FoHF manager should exercise greater vigilance;

- it is vital for the FoHF manager to assess the potential risk associated with each of the underlying funds in which he is invested.

These aspects should be monitored at all times, a point illustrated by the recent difficulties of hedge funds with exposure to the sub-prime mortgage market.

In it findings, the working group stressed the importance of:

- risk diversification requirements for ARIA III funds. These requirements should apply both to the number of underlying funds and to the strategies they pursue. The group agreed unanimously that the current arrangements in this area should not be diluted too much;

- a robust risk monitoring system at the FoHF and the underlying hedge funds. Also, efforts must be made to build trust with the managers of underlying hedge funds. The aim is to ensure that, as far as possible, the information needed to assess the actual situation is available whenever necessary.

- proper monitoring of liquidity risk, particularly in the case of underlying funds with illiquid or complex assets, which also raises the question of having appropriate procedures for redeeming units in these funds;

- the regulator's requirements concerning the scope of the FoHF manager's due diligence duties, especially if these partly replace the ex ante eligibility criteria for underlying funds.

Considering the lessons of Amaranth, the working group believes that the main areas of leeway for upgrading France's regulatory system for FoHFs lie in enhancing the efforts and procedures of FoHF managers for monitoring underlying funds and the operational impacts resulting from those inputs.

II.3. Regulatory arbitrage needs to be considered to minimise unwanted effects on investor protection

The increasing number of options for retail investors in Europe to gain more or less direct exposure to the hedge fund market was a major factor in the AMF's decision to evaluate the FoHF framework.

The collective investment industry has to contend with an unfair playing field in which different legal regimes and wrappers give access to financial products pursuing similar investment strategies while having to comply with very different regulatory restrictions.

In a risk mapping exercise published on 9 January 2007, the AMF noted that the entire spectrum of collective investment products could be accessed through a range of legal frameworks (insurance, banks, collective investment), with differing requirements terms of transparency, tax treatment, and the regimes applicable to intermediaries.

This situation is especially true in the case of hedge funds, because retail investors can gain exposure to them through exchange-traded certificates, closed-end listed hedge funds, some unit-linked life insurance policies, FoHFs or under individual discretionary mandates[28].

For the regulator, these options raise the question of which investor protection framework can most effectively cover financial products with fairly similar risk/return profiles but different legal/tax wrappers. In the first analysis, regulated FoHF investing has useful qualities from an investor protection perspective, to the extent that it "places special responsibility (…) on the managers of funds of funds by requiring them to be in a position to exercise due care with regard to underlying funds"[29].

[28] Part One of the report deals with these key aspects.
[29] Cf. closing speech by Michel Prada at a conference on hedge funds organised by Premier Cercle in association with *The Wall Street Journal* - see AMF monthly review No. 32, January 2007.

Furthermore, the Committee of European Securities Regulators (CESR)[30] recently ruled that hedge fund indices were eligible for retail UCITS, subject to certain conditions. Accordingly, a close watch must be kept to prevent regulatory arbitrage in favour of products for which the manager due diligence requirements are less stringent than those routinely encountered.

The working group is proposing rules that will not put French FoHFs at a competitive disadvantage relative to other financial products with similar risk exposure and strategies, while at the same time preserving their basic qualities in terms of investor protection.

II.4. The international context is an incentive to ensure that domestic standards are appropriate, so that they can be promoted among international institutions and foreign investors

Several international bodies, including IOSCO and a number of European organisations, have given FoHFs a central place in their discussions and initiatives.

Their efforts form part of a broader debate aimed at extending the distribution of alternative investment products.

II.4.1. At the international level, IOSCO's standing committee on investment management (SC5)[31], was given a mandate in February 2007 to study the regulatory issues raised by FoHFs. The AMF is in charge of this mandate, which builds on SC5's earlier work on hedge funds.

An SC5 report published in 2006 revealed that many jurisdictions worldwide are showing mounting interest in the question of appropriate regulatory treatment for hedge funds . The report showed that 18 of the 20 largest financial centres already regulate hedge funds. Since approaches vary fairly widely from country to country, IOSCO decided to place the emphasis on identifying the information that needs to be disclosed to investors, such as fees, risk exposure, manager experience, internal controls and conflicts of interest. It was also decided that future work should concentrate on FoHFs, because IOSCO members felt that this type of fund was set to become the main vehicle for making alternative management techniques available to the general public.

Following on from this, on 20 April 2007 IOSCO launched a public consultation aimed at eliciting stakeholder views about the regulatory issues raised by FoHFs[32]. Once the various risks and issues have been identified, IOSCO will begin drafting standards in 2008 as part of a process involving SC5 regulators and representatives from the alternative investment industry. The new standards will deal mainly with due diligence requirements for FoHF managers.

II.4.2. The White Paper published by the European Commission in November 2006[33] has been the focal point of discussions **in Europe**, although a major debate has also taken place within CESR as part of that committee's work on the eligibility of hedge fund indices for UCITS.

[30] Decision published on 17 July 2007.
[31] SC5's objective is to periodically analyse developments in professional practice and the regulatory requirements arising from such changes. Accordingly, it regularly proposes common regulatory standards based on its members' best practices. The AMF currently chairs the committee.
[32] Cf. IOSCO document "Call for views on issues that could be addressed by IOSCO on funds of hedge funds" (April 2007). (http://www.iosco.org/library/pubdocs/pdf/IOSCOPD244.pdf).
[33] Cf "White paper on enhancing the single market framework for investment funds", 15.11.2006, (Com(2006) 686 final).

On 5 February 2007, CESR began a consultation[34] that asked whether hedge fund indices could be eligible for UCITS provided they complied with certain criteria, namely sufficient diversification, representing an adequate benchmark, and publication in an appropriate manner.

During the consultation stages, the Consultative Group advising CESR's Investment Management Expert Group said it was disappointed that FoHFs were not distributed more widely in Europe, but that such an outcome could be achieved through UCITS replicating the performance of a hedge fund index[35]. On 17 July 2007, CESR published guidelines[36] concerning the eligibility of hedge fund indices for UCITS and, more specifically, the criteria that these indices must meet to be classified as financial indices for the purpose of UCITS. The guidelines also clarify the due diligence that must be performed before exposing a UCITS to a hedge fund index.

Accordingly, any evaluation of the consistency of the French regulatory framework for FoHF must consider the risks of regulatory arbitrage between UCITS that invest in hedge fund indices and French investment schemes investing in hedge funds, which cannot be harmonised.

II.4.3 The AMF's fellow regulators in Europe have also taken initiatives in this area, particularly with a view to promoting wider distribution of FoHFs. Some important developments have recently taken place in the UK.

In March 2006, the UK's Financial Services Authority (FSA) began a public consultation [37] on a framework for retail FoHFs. As part of this initiative, the FSA talked about possible quality criteria to be applied to underlying funds, such as making funds subject to annual audits, having their value verified by persons independent from the operator, having mechanisms to allow unitholders to redeem units within a reasonable time, and requiring funds to operate in line with the principle of risk spreading.

Building on this initiative, the FSA launched a new consultation on 27 March 2007[38] in which it proposed allowing UK regulated open-ended non-UCITS to invest up to 100% of their assets in hedge funds or private equity funds[39]. These non-UCITS schemes could be sold to retail customers without special restrictions. In return, fund managers would have to operate with due diligence.

The FSA paper highlights the importance of having a secure process for marketing this kind of product to retail customers. The information conveyed by managers and distributors to final investors, and the conditions under which these products are marketed, form key elements of the FSA's regulatory model for FoHFs.

These international-level discussions and initiatives reflect the major challenges associated with the rise of FoHF investing. They also created an incentive for the working group to conduct a careful analysis of the impact of initiatives by European regulators to regulate FoHFs.

[34] CESR public consultation paper entitled "Clarification of the definitions concerning eligible assets for investment by UCITS: can hedge fund indices be classified as financial indices for the purpose of UCITS?"(CESR/07-045). The closing date for contributions was 16 April 2007.
[35] Cf. paragraph 23, page 8 of the CESR public consultation paper "Clarification of the definitions concerning eligible assets for investment by UCITS: can hedge fund indices be classified as financial indices for the purpose of UCITS?" (CESR/07-045).
[36] Cf. "CESR's guidelines concerning eligible assets for investment by UCITS - The classification of hedge fund indices as financial indices" - Ref: CESR/07-434 - July 2007.
[37] Cf. FSA Feedback statement 06/3 published under the title "Wider-range Retail Investment Products: Consumer protection in a rapidly changing world - Feedback on DP05/3" - March 2006.
[38] The consultation closed on 27 June 2007.
[39] Cf. FSA Consultation Paper "Funds of Alternative Investment Funds" - March 2007.

II.5. Positioning France's financial centre effectively with a view to future European developments

In July 2006, the European Commission's expert group on hedge funds welcomed the fact that some Member States allowed FoHFs to be marketed to retail investors[40] and said it supported the idea of widening the distribution of FoHFs to non-qualified investors and on a cross-border basis. Although the group initially considered the question of creating a European regime for FoHFs that would allow these funds to be passported within the European Union (EU)[41], in the end it recommended a completely different approach that turned out to be hard to put into practice[42].

In its response to the expert group's report, AFG said that cross-border distribution of FoHFs required an appropriate European regulatory framework and could not be based solely on the provisions of the Markets in Financial Instruments Directive (MiFID). In this respect, AFG suggested either including FoHFs in the scope of the UCITS Directive or creating a dedicated European regime for non-UCITS. AFG has since reiterated this recommendation several times in its responses to European consultations.

Responding to the expert group's report, the AMF Board said that among the interesting ideas proposed, "the one with the greatest near-term potential is the recommendation that FoHFs should be distributed more widely", and called for the creation of a "European system for FoHF that would be based on appropriate regulation of industry participants and on a minimum set of measures to be taken by the fund of funds manager to ensure optimum security for retail investors. From a regulatory perspective, this seems to be the only viable approach. Member States are unlikely to automatically grant mutual recognition to each other's hedge fund regulations unless a common standard emerges. In any case, France could not recognise national regulatory frameworks that do not offer sufficient guarantees."[43].

Admittedly, the European Commission's November 2006 White Paper on Asset Management did not identify the creation of a European regime for FoHFs as an immediate priority. But the Commission did announce that it would hold overall discussions on the cross-border sale of non-UCITS, focusing for the time being on practical measures for real estate funds. Furthermore, in a June 2007 working document, Wolf Klinz, the European Parliament's rapporteur for the Commission White Paper, called on the European Commission to put hedge funds on its agenda.

In a hearing before the working group on 9 May 2007, the European Commission representative clarified the Commission's views, saying that five issues had to be resolved before a Community initiative in the area of hedge funds could be considered:

- Given that the current version of the UCITS regime (set out in the amended UCITS Directive) cannot be used to promote the development of the FoHF industry, what criteria are FoHFs

[40] Cf. Report of the Alternative Investment Expert Group to the European Commission entitled "Managing, Servicing and Marketing Hedge Funds in Europe" - July 2006: "Several Member States have authorized the sale of funds of hedge funds to retail investors on the grounds that they provide diversified exposure to this asset class. This has been the case inter alia, in France, Germany, Ireland, Luxembourg and Spain. Whilst there are concerns regarding the level of product regulation that some of these regimes introduced, <u>the Group welcomes this approach and believes fund of hedge funds (or well diversified hedge funds) could provide significant benefits to a wide range of investors for whom the case may be that investment in single hedge funds is not appropriate.</u>"

[40] Cf. Report of the Alternative Investment Expert Group to the European Commission entitled "Managing, Servicing and Marketing Hedge Funds in Europe" - July 2006 "The Group gave some consideration to possible adjustments to the relevant provisions of the UCITS Directive to allow a broader population of funds of hedge funds to be authorised and marketed across Europe as UCITS … the Group decided against such a course of action."

[41] The expert group recommended a system of mutual recognition of FoHFs authorised by individual Member States for sale to retail investors, and said that these funds could be distributed under MiFID provisions. This approach proved tricky to implement insofar as it required a far-reaching interpretation of MiFID. Cf. in particular the response by the European Fund and Asset Management Association (EFAMA) to the Expert Group's report ("the possibility of distributing non UCITS under MIFID without any marketing restrictions beyond MIFID suitability requirements (…) requires a very far-reaching interpretation of MIFID which (…) would significantly strengthen the competitive position of non UCITS").

[42] Cf. "Response by the Autorité des marchés financiers (AMF) to the reports by the European Commission's expert groups on asset management" published on the AMF website on 30 October 2006.

and their underlying funds failing to meet in order to be eligible for the provisions of Europe's UCITS regime?

- are FoHFs appropriate for retail investors in terms of performance, risk/return, etc.?[44]

- what are the differences and similarities between the domestic regimes set up by Member States to regulate FoHFs? To what extent is convergence possible?

- do the benefits of allowing retail investors to access these funds outweigh the drawbacks, particularly given the difficulties involved in establishing a regime of this sort at the European level?

- if there is a presumption in favour of a European regime for FoHFs, what is the best way to establish it?

  Possible courses of action are as follows:

  (i) mutual recognition of FoHFs as they are currently regulated at the domestic level in Member States;
  (ii) extension of the amended UCITS Directive to encompass FoHFs;
  (iii) introduction of a separate harmonised regime for FoHFs that would coexist with the UCITS regime.

The Commission representative said that Commission would present a report to the Council and the Parliament in mid-2008 on the benefits of adding provisions for certain non-UCITS to the UCITS regime.

The report will also consider the benefits of continuing work on a possible European framework for FoHFs.

It was also stressed that passporting non-UCITS that can compete with UCITS might drastically reduce the incentive for European managers of collective investment products to comply with the requirements of the amended UCITS Directive. The AMF consultation paper mentioned this risk.

Although feedback to the consultation noted this risk, there was overwhelming support for a European regulatory framework for FoHFs as a way to establish a level playing field for different products that pursue relatively similar investment strategies and that are now distributed to retail investors.

Most of the responses supported the notion of establishing a uniform European framework and common standards for FoHF investing, and agreed that FoHFs should be passportable within the EU. According to the feedback to the consultation, introducing a European FoHF regime would not rob the amended UCITS Directive of its substance.

But doubts were expressed about the speed with which such a regime could be put in place. Accordingly, respondents suggested that one course of action might be to introduce a European private placement regime, which could be implemented quickly. This option would also be preferable to a system of mutual recognition among EU authorities.

The working group is calling for the creation of a European passport system for FoHFs. In conducting this project, the group took into account the future introduction of harmonised European regulatory standards for FoHFs. Such standards are a necessary condition for the creation of a European passport system for this type of fund.

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[44] Section I. 4 of this report is intended to contribute to this debate.

Once it had finalised its assessment and clarified the domestic and international context surrounding its evaluation exercise, the working group set itself the task of formulating recommendations to enhance the regulatory framework for FoHFs in France.

It was agreed that adjustments to the rules for French FoHFs (Part III of the report) had to be accompanied by a clearer, formal framework that gives management companies greater responsibility for carrying out due diligence (Part IV of the report).

The working group noted that the programmes of operations that companies already have to submit for AMF approval supply much of the basic foundation for such a framework. However, clarification should be provided so that this framework can underpin FoHF regulations in France as well as the standards that are currently being drafted at the international level.

The working group's recommendations, to be applied in a setting where well organised management companies conduct appropriate due diligence on properly regulated ARIA III funds :

- **Seven product-related recommendations that adjust the rules applicable to French FoHFs, while ensuring that investors continue to be offered products with controlled risk;**

- **Four recommendations for participants to ensure that management companies exercise due diligence in an appropriate, supervised framework.**

III. Seven product-related recommendations that adjust the rules applicable to French FoHFs, while ensuring that investors continue to be offered products with controlled risk

Of the seven recommendations proposed by the working group, the one related to the 13 eligibility criteria for underlying funds would mark a major shift in the regulation of FoHF investing in France.

The working group's principles-based approach thus has implications for the framework of the regulation to be applied to management companies, as detailed in Part IV of this report.

III.1. Concerning the eligibility of underlying hedge funds, adopt a principles-based approach so as to mitigate the "yes/no" nature of the 13 current eligibility criteria

- Current state of regulation concerning prior eligibility criteria for underlying funds

Initially, these "common sense" criteria were designed to ensure a sufficient level of security for French funds investing in foreign collective investment vehicles and carrying certain risks. The 13 regulatory criteria offered a standard framework that was useful in limiting the investment universe to those funds presenting sufficient financial security and legal certainty.

These 13 criteria can be classified as follows:

- guarantees regarding ownership of the units of the underlying fund (**Criterion 1**), details of custodian arrangements (**Criteria 4 and 5**), re-use of these units by the custodian or its agents (**Criterion 6**), existence of rights and obligations arising from the underlying fund's own assets and liabilities (**Criterion 3**);

- principle of equal rights for all investors in the underlying fund (**Criterion 2**);

- registration of the fund manager and supervision by a regulatory authority (**Criterion 7**);

- annual certification of the financial statements by an independent auditor (**Criterion 8**);

- disclosures to fund investors: net asset value or estimate thereof available at least monthly (**Criterion 12**), quarterly or more frequent disclosure of information about the management of the underlying fund (**Criterion 11**), prospectus explaining the investment and organisational rules governing the underlying fund (**Criterion 10**);

- limitation of investors' losses to the amount of their investment (**Criterion 9**);

- exclusion of underlying funds created in non-cooperating countries or territories on the FATF list (**Criterion 13**).

- Difficulties encountered by management companies and custodians in enforcing and checking compliance with the 13 eligibility criteria

The 13 criteria were introduced in 2003, the AMF has since become aware of certain interpretational difficulties[45], although these have not slowed the development of hedge funds in France.

[45] On 18 December 2006, in light of the 23 June 2006 ruling by the Federal Court of Appeals of the District of Columbia, the AMF had to clarify the interpretation of the criteria requiring that managers of foreign investment funds be subject to the supervision of an authority that regulates their activities and with which they are registered. It thus established a grandfather clause for funds whose managers had deregistered from the SEC.

In general, the members of the working group also emphasised the difficulties in interpreting and applying certain criteria, which has often put FoHFs in an uncertain legal position when selecting an underlying fund. This is because they must either eliminate the targeted fund from their selection, thereby losing a potential investment opportunity, or select the fund, with the attendant non-compliance risk.

It was also mentioned that to comply with some of the criteria, the management company must obtain specific information from prime brokers. In practice prime brokers do not always supply the requested information, especially if the management company is not large enough to meet their criteria.

The members of the working group pointed out that:

- the 13 criteria were drafted on the basis of "common sense", even though problems of interpretation or implementation persist, in particular on Criteria 5 and 7;

- it was primarily the "yes/no" nature of the criteria that posed a problem. This situation should prompt the regulator to concentrate on a verification approach that is in line with its overall policy, which emphasises the responsibility of fund managers in conducting due diligence[46];

- Criterion 7 on the "supervision by an authority that regulates these activities and with which the entity is registered" continued to pose a specific problem for funds with managers located in the USA and thus limited the universe of possible underlying funds. It was acknowledged that although the AMF's grandfather clause merely maintained the current state of affairs, it had the advantage of responding to an urgent situation. The idea of a letter of reference or even a letter indicating the financial health of the managers of underlying funds, to be provided by the prime broker, was suggested as a way to circumvent this specifically American problem;

- Criterion 7 also presented a problem for funds registered in Switzerland (where hedge funds are often managed by unregulated entities);

- the hardest criteria for management companies to check exhaustively were those related to custodian arrangements; at the same time, however, these criteria were essential to ensuring the security of on-shore hedge funds and guarding against the risk of fraud;

- a rating could serve as a form of confirmation of the analysis performed by the management company.

A new regulatory approach based on giving management companies responsibility for due diligence would be in line with the approach recommended by the AMF's counterparts in other European countries and with CESR's recommendation on the eligibility of hedge fund indices.

[46] See article entitled "*La responsabilité des sociétés de gestion dans la détermination de l'éligibilité des actifs pour l'investissement par des OPCVM*" ("The responsibility of fund managers in determining the eligibility of assets for investment by UCITS"), in the AMF's monthly review, no. 35, April 2007.

In view of the disadvantages of the "yes/no" (or "cut-off") nature of ex ante eligibility criteria for the underlying hedge funds, the working group recommends that these criteria should be transformed into more general principles concerning certain crucial legal, operational and organisational aspects of the underlying hedge fund. The FoHF manager would be required to examine compliance with these principles before any investment is made.

- A principles-based approach is a relevant basis for FoHF manager due diligence when selecting underlying hedge funds

This principles-based approach consists in ensuring the FoHF manager will have analysed the key legal, operational and organisational aspects of the hedge fund before investing in it. The objective is to minimise legal, operational and fraud risks, so as to protect investors' interests.

These principles would be included in the AMF General Regulation and would replace the current 13 criteria. They could be presented as follows:

"As part of its due diligence prior to investing in a hedge fund, the management company shall ensure:

1) that the rights attached to the instruments in which the assets of the fund are invested exist and can be enforced at all times;
2) that the assets of the underlying fund are held separately from those of the custodian and the agent;
3) that the shares or units held by the fund are valued appropriately at least once a month and that there is a legally binding requirement for the financial statements to be audited or legally certified at least annually.

Funds incorporated in non-cooperative countries or territories on the Financial Action Task Force List shall be excluded."

The AMF General Regulation would thus refer to these principles and to the programme of operations of the FoHF management company. The programme would be considered as a formal commitment by the company to the regulator with regard to its expertise, skills and resources for selecting and monitoring the underlying funds, as well as the existence of an appropriate risk management system and appropriate methods for marketing FoHF units[47].

Nevertheless, enforcement of these principles would not prevent a management company from using some or all of the 13 criteria to comply with the principles of the AMF General Regulation.

There are two options for clarifying and providing further details about the principles inserted into the AMF General Regulation.

The first option would be to allow each management company to specify through its own procedures how it intends to comply in practice with the principles of the AMF General Regulation. While this option has the advantage of giving companies complete freedom in conducting due diligence, it can also leave them in an awkward situation of legal uncertainty as to whether their procedures comply with the principles of the AMF General Regulation.

The second option would consist in allowing the industry associations that represent each of the participants, i.e. management companies and custodians, to draft a professional code that could then be approved by the AMF and used as a basis for sanctioning any infringements. This option would rely heavily on industry self-regulation. It would enable the industry to develop consensus-driven standards that are consistent with the economic model of the French financial centre. The disadvantage, however, is that there would be no indication of when such a code might be produced or whether it would be approved by the AMF.

[47] Part IV.1 of this report provides detail on these commitments.

These two options could be founded in part on existing standards, in particular those issued by AIMA[48] and IOSCO[49], especially those concerning the valuation of illiquid or complex assets held by hedge funds.

The consultation period following publication of this report should provide useful indications regarding the option to be chosen.

This principles-based approach would not be firmly rooted unless it relies on management companies that are well-organised and capable of carrying out due diligence and providing evidence of this ex post.

It also assumes that the regulator switches its supervisory procedure from strictly applying ex ante eligibility criteria for underlying funds to ensuring ex post that FoHF managers apply general principles that make them responsible and accountable for conducting due diligence[50]. Part IV of the report deals with this subject in more detail.

III.2. Maintain the principle of a minimum number of underlying funds

- Current regulations require French FoHFs to invest in at least 16 underlying funds

Under the general regulations applicable to collective investment schemes[51], ARIA III funds must comply with the risk spreading or diversification rule applicable to fund investments (the so-called 5/10/40 ratio). This ratio implies that they must invest in at least 16 funds. The 5/10/40 rule states that no one investment can represent more than 5% of the portfolio, with the exception of four investments, which can represent 10% individually and 40% collectively. For a fund that is fully exposed to hedge funds, the minimum number of components is therefore 16 (four with a weighting of 10% and 12 with a weighting of 5%).

This minimum of 16 funds must be seen in perspective, since the minimum number envisaged in the FSA public consultation document is three.

The 5/10/40 rule is being changed. It is likely to become a 10/15/40 rule, which means the minimum number of funds would be nine.

[48] The Alternative Investment Management Association (AIMA) is an international association of alternative investment professionals, present in 47 countries.
[49] See Part IV.2 of this report.
[50] The contribution of Paul Zariffa, member of the working group, addresses this issue (see Annex 8 to this report).
[51] Article L. 214.4 of the Financial and Monetary Code and Article 3 of Decree no. 89-623.

- Academic research suggests that the optimum risk spread for FoHF portfolios is a minimum of around 10 underlying funds

The working group paid a great deal of attention to the question of the appropriate minimum level of diversification for a FoHF, relying on a study by two of its members[52].

Academic research has shown that optimum portfolio diversification requires a minimum of between five and ten components. Given the biases inherent in this research (survivorship bias in the funds in the databases, non-recognition of structural and cyclical correlation between funds), this minimum can be considered underestimated.

The working group agreed that this work provides a solid statistical basis for the current risk spreading rule applicable to French FoHFs, even though there is no "magic number". Moreover, some members of the working group had an even more cautious approach than that required by French regulations. They would limit the proportion of total FoHF assets invested in any single hedge fund to 8% or even much less, thereby factoring in the impact of the potential failure of an underlying fund in addition to the question of correlation.

Most importantly, the working group stressed that it was necessary to consider possible correlations between the strategies and performances of the various underlying funds when studying the diversification of FoHFs. The issue of diversifying a portfolio or a FoHF cannot be addressed simply by mandating a minimum number of funds.

Some working group members indicated that diversifying the financial risks of a FoHF did not necessarily require a large number of underlying hedge funds. A "risk budget" approach, using the contribution of each position to the overall risk of the portfolio, might also be useful in measuring portfolio concentration. Diversifying operational risk should be addressed with an insurance-type approach based on a breakdown ratio (5/10/40, for example).

AMF regulations allow investors and management companies to invest in other types of funds (e.g. contractual funds, unleveraged ARIA funds) with less restrictive rules in terms of risk diversification.

- Sufficient diversification of regulated FoHFs requires an investment in at least 10 underlying funds, which corresponds to current practice

The working group therefore concluded that the current ARIA III diversification rule contributed a degree of security to the system as regards risk, particularly in light of the lesson the market has learnt from the failure of the Amaranth fund[53].

The working group believes that the current level of diversification over 16 or more funds – common practice today in the French market – is appropriate. It recommends that in any case, the minimum not be set lower than some ten underlying funds, so as to ensure appropriate diversification of FoHF assets. It could be useful to bring up this diversification rule, which is based on recognised scientific research, in international discussions intended to develop standards for retail hedge fund products.

[52] See Annex 7 to this report: "Hedge funds and portfolio diversification"
[53] See Part II. 2 of this report.

III.3. Authorise three-tier structures for French FoHFs in some cases and allow them to invest in hedge fund derivatives provided they comply with certain conditions

- Current state of regulation regarding cascades of funds and issues related to authorising them

Funds of funds of funds, or "F3s", are currently prohibited in France. The working group wanted to examine the possible benefits of F3s so as to enable FoHFs to invest in other ARIA III funds or in ARIA I FoHFs. This would make it possible to offer funds of FoHFs to retail investors.

An FoHF manager with skills in a particular area but not in specific strategies could then round out his allocation by investing part of his fund's assets in another ARIA III, managed by another French management company. This would broaden the scope of investments available to fund-of-fund managers.

- Working group recommendation: authorise funds of FoHFs under certain conditions

Current regulations do not authorise F3s because of the additional layers of cost.

Moreover, by increasing the number of fund managers, it becomes difficult for the investor and the regulator to determine the responsibilities of each of them. Concerning this last point, it was agreed that an ARIA III could invest only in other ARIA III funds or in ARIA I FoHFs (whose management company is always AMF-regulated) or in funds governed by the laws of a foreign country and authorised for sale in France (whose fund manager is known to the AMF). In this way, the AMF would be able to determine the accountabilities of each participant in the structure.

The working group recommends that funds of FoHFs be authorised, but only under the following conditions:

- there must be full transparency on fees and expenses. Provision must be made for the expenses of the underlying ARIA III funds or ARIA I FoHFs to be included in the management fees of the top-level ARIA III;

- any fees rebated between the top-level fund and the underlying funds must be retained by the top-level fund;

- the underlying funds of funds must be approved by the AMF or authorised for sale in France.

- Current state of regulation regarding investment of ARIA III funds in hedge fund derivatives

The working group also examined the possibility of allowing ARIA III funds to invest in hedge funds not only directly but also through financial instruments with embedded derivatives. The AMF's current policy allows investment in such instruments only if they do not include an option.

The objective would be to enable ARIA III funds to take option positions on hedge funds. Some working group members felt that this could be a useful management tool in certain circumstances.

Until now the AMF has not entertained this possibility, for two main reasons:

- the reliability, or even the possibility, of pricing derivatives with embedded options has not yet been proven, in a context where ARIA III funds can offer investors weekly liquidity;

- the leverage of derivatives with embedded options could have very significant consequences for the risk profile of ARIA III funds.

- Working group recommendation: authorisation under the responsibility of the fund manager

The majority of the working group was in favour of using derivatives with embedded options under the following conditions:

- that the management company can demonstrate to the regulator that it is able to value them accurately and independently on an ongoing basis;

- that it explains in its prospectus how the use of this type of derivative will affect the risk profile of its fund, in particular when the products are highly leveraged.

III.4. Cost transparency requirements must be in line with those for conventional funds of funds

The working group examined the following issues: transparency of the expenses borne by underlying funds, remuneration of prime brokers and the impact on Part B of the ARIA III fund's full prospectus.

The working group members considered that cost transparency should apply essentially at the level of the FoHF manager. They were of the opinion that transparency on the detail of expenses borne by each underlying fund is neither useful nor realistic from an operational point of view. It is not appropriate to go beyond what French regulations already require. The regulation applicable to conventional funds of funds is also applicable to French FoHFs.

Even if it were desirable to obtain specific information on the costs of the underlying funds, it would be unrealistic to calculate those expenses beforehand. This prompted the working group members to put priority on more general investor disclosures, where the various types of expense borne by the underlying hedge funds would be clearly mentioned. As historical costs can be calculated precisely, these should be clearly indicated to the final investor.

Concerning ex post disclosure of the actual costs borne by investors, several working group members mentioned the difficulty in calculating the total expense ratio[54], e.g. in the case of underlying funds with different account closing dates.

The members of the working group reiterated that final investors must receive clear, aggregate, comprehensible information (including turnover fees in particular). The investor must be made aware of the cost of selecting and monitoring the underlying funds.

The working group believes that French regulations on costs applicable to conventional funds of funds can be applied to French FoHFs. The total expense ratio must give an accurate and truthful indication of the expenses borne by the final investor. The investor must be made aware of the cost to the FoHF manager of selecting and monitoring underlying funds and be given an overall idea of the expenses borne on all the underlying funds.

[54] The TER measures the fund's management fees and other operating expenses.

III.5. Communicate more clearly about the characteristics of French FoHFs

- Difficulties related to the AMF's classification of French FoHFs

Some members of the working group, echoing comments made during the consultation period, spoke of difficulties caused by putting FoHFs under the umbrella term ARIA III, which is in turn a subset of the broader AMF classification called *OPCVM de fonds alternatifs* (funds of hedge funds).

The ARIA III category, which includes a broad range of funds with diverse characteristics, lends credence to the investor notion that alternative investments – and to an even greater extent, FoHFs – are an asset class in their own right. This does not appear to correspond to the facts.

In addition, it was pointed out that this classification, compared with that applied to more conventional asset management, could cause confusion that would be prejudicial to management companies vis-à-vis rating agencies, which publish so-called "star" rankings and ratings, and possibly vis-à-vis certain wholesale investors who could be unsettled by the word "*alternatif*".

The working group members also noted that one of the problems with the AMF classification stems from the fact that funds are required to be classified as *OPCVM de fonds alternatifs* and are considered part of the hedge fund universe once their exposure to hedge funds exceeds 10% of assets.

The working group wondered whether the threshold exposure to hedge funds of 10% made sense. This is particularly the case with so-called hybrid funds, where most of the portfolio is invested in or exposed to long-only instruments and also includes a hedge fund component that exceeds the 10% threshold but accounts for a minority of overall assets. Applying the 10% threshold automatically shunts these funds into the *OPCVM de fonds alternatifs* regulatory category, which might not reflect the minority nature of their alternative investment exposure, particularly in the eyes of investors.

Nevertheless, the working group preferred not to recommend a change in the AMF classification at this time. It did express the desire to see rating agencies acquire a better understanding of the real nature of alternative investing. It recognised that the regulator and management companies should work together to improve the information supplied to rating agencies and investors – both retail and wholesale – about the characteristics, investment policies and risk profiles of French FoHFs.

It recognised that classification always engenders rigidity, which potentially conflicts with the inherent flexibility of alternative investing. There is no classification system that can reflect the variety of investment strategies and risk profiles of hedge funds. Any choice of categories or classifications causes problems of uniformity, either from a regulatory point of view or in relation to rating agencies. This classification problem is equally present, if not more so, in the universe of *OPCVM diversifiés* (diversified collective investment schemes).

The high cost of changing fund classifications, both for management companies and for the AMF, was also taken into account. These costs would not necessarily be outweighed by the benefits to be derived from the changes.

- Ways of improving communication and disclosure about French FoHFs

The working group stressed that investment fund distributors must produce information of a huge standard. Distributors have the important responsibility of informing investors in a "clear, straightforward and faithful" manner about the nature of investments, asset classes and, especially, the investment strategies to which they subscribe.

Fund managers are required to prepare a full prospectus that "provides the essential information necessary for an investment decision, is written in an easily understood fashion […] and gives complete, clear and transparent information enabling the investor to take a fully informed investment decision". However, prospectuses are often supplemented by commercial materials and marketing programmes (target customers, sales training, etc.), which frequently come to the attention of the AMF. The information contained in regulatory or marketing documents is often very similar from one fund to another and does not take into account the intrinsic characteristics of the vehicle in question.

In addition, these marketing programmes do not always enable the AMF to evaluate the quality of the information actually disclosed to investors or the skills or level of training of the individuals in charge of selling FoHFs.

Further to these concerns, some members of the working group noted that the measures for gauging the risk profiles of hedge funds, such as volatility or the Sharpe ratio, are not always appropriate for measuring the funds' specific risks, even though they are frequently used by the promoters of FoHFs. These indicators do not provide the information necessary to understand the investment strategies and atypical risks of hedge funds and FoHFs.

The working group recommends two ways of raising the standard of the information disclosed to the public about the characteristics of French FoHFs. The first deals with disclosures about investment strategy and the second with the funds' risk/return profile.

Concerning the investment strategy, most prospectuses are not currently written in such as way as to differentiate the dominant strategy and the risk/return profile of a *OPCVM de fonds alternatifs* from other funds in the same category.

Concerning the risk/return profile of French FoHFs, fund managers should replace or supplement the measures usually employed with information more closely related to the strategies of the hedge funds in the fund. In particular, it is imperative to emphasise the risks involved in investing in relatively illiquid funds, alongside the high performance targets highlighted in the prospectus.

The working group recommends that prospectuses should give a clearer explanation of the risk indicators used for the fund and of the risk/return profile.

III.6. Maintain the current minimum investment amounts for French FoHFs, while ensuring the funds are marketed appropriately

The working group examined the idea of changing the minimum investment for retail investors in French FoHFs. It took into account the wide range of thresholds in other European countries[55].

Starting with the idea that FoHFs can be genuinely useful in diversifying a financial portfolio[56], the working group endeavoured to establish the best criterion for retail access to this type of product. One possibility might be a ratio of the amount of the investment in a French FoHF to the investor's total financial wealth. But even putting the questionable nature of this approach to one side, implementation and especially oversight of compliance on the part of distributors seemed too fraught with pitfalls to be practical.

The working group, in line with the majority of responses received during the consultation period, adopted a more conservative approach concerning retail distribution of French FoHFs. It decided that it should neither encourage nor discourage the sale of this type of product to relatively unsophisticated individual investors.

[55] See Annex 4 of this report.
[56] See Annex 6 of this report, entitled "Taking Stock of ARIA funds"

It agreed that to prevent improper promotion of this type of product the distributor must perform appropriate due diligence when advising its customers. For French FoHFs, this refers to the suitability[57] test in MiFID.

Given that the €10,000 threshold had neither hampered the development of hedge funds nor prompted requests for changes, whether from management companies or investors, the working group recommended that this threshold be maintained for French FoHFs.

After a comparative analysis of the situation in other EU countries, the vast majority of working group members recommended that the minimum investment for French FoHFs should be maintained at €10,000. The working group also stressed the importance of due diligence on the part of the distributor so as to prevent inappropriate sales or mis-selling to unsophisticated retail investors.

III.7. Delegation

Current regulations allow a management company[58] to outsource the selection of underlying funds, investment monitoring and portfolio valuation to external companies, under a formal delegation agreement and subject to a specific review by the regulator.

The company proposing a delegation arrangement must demonstrate that it has verified the resources of the delegatee company and has put in place a system for overseeing the company's work. Such oversight also implies the existence of human and technical resources as well as specific reporting procedures and warning systems.

This delegation can be authorised only if the delegatee is a (French or foreign) management company belonging to the same group as the delegating company or if it is a French management company external to the group but with a specific FoHF programme of operations. The COB and then the AMF felt that it would be difficult for the delegating company to impose the principles and resources defined in its best practices manual on a foreign company that does not belong to the same corporate group.

Accordingly, companies wishing to delegate their FoHF activity must submit a special programme of operations focused on the skills, resources and oversight procedures for the delegation arrangement, the marketing and investor disclosure procedures, and the rules for reporting by the delegatee.

The working group believes it would be premature to express an opinion on this system, as the AMF is currently examining the problem of delegation for all asset management activities (collective and individual). New regulations in this area may be adapted to FoHF management, if appropriate, once the AMF's work is completed.

The working group believes that changes to the delegation framework in respect of FoHFs could be considered once the AMF's work on delegation in the areas of fund management and discretionary mandates is completed and in light of any new direction to which this work may lead.

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[57] In the suitability test provided for in the Markets in Financial Instruments Directive, No. 2004/39/ EC (MiFID), the service provider must ensure that the service meets the objectives of the client, that the client can assume the risks related to the transaction and that it has sufficient knowledge and experience.
[58] See the list of COB decisions, April 2003.

Part IV of the working group report addresses the question of whether the fund manager’s resources, organisation and control procedures are in line with the specific nature of the hedge fund strategy it employs.

IV. A profession structured around well organised, effectively supervised management companies conducting appropriate due diligence

Management companies implementing fund of hedge fund strategies are now required under prevailing regulations to have the resources, organisational structure and supervisory procedures required to carry on their business.

When submitting a specific programme of FoHF operations to the AMF Board for approval, the companies must demonstrate that their organisational structure is robust.

The programmes of operations prepared by FoHFs provide a secure framework for a principles-based regulatory approach as recommended in Part III of this report. A number of points will obviously need to be clarified in order to reassure investors that an appropriate framework is in place for the due diligence procedures conducted by management companies.

IV.1. Building on existing programmes of fund of hedge fund operations approved by the AMF

- Programmes of operations submitted by management companies and approved by the AMF are a key regulatory option that the market could capitalise on

Since 2003, management companies wishing to carry on a FoHF business have been required to draw up a specific programme of operations describing the resources they implement for this activity.

This programme of operations is subject to prior AMF approval before any money can be invested in a foreign non-UCITS.

In its programme of operations, the management company must demonstrate that it has the expertise and skills necessary to carry on its FoHF business successfully and that it has a series of documented procedures for selecting and tracking its investments.

The COB's April 2003 decision statement on regulating FoHFs identified five key angles for assessing whether funds meet this requirement:

- *"the expertise and experience acquired for this type of investment management (strategic asset allocation, fund selection, management of underlying funds), particularly as regards the formation of the management team;*
- *the procedures for selecting and monitoring investments. Investments should be selected by applying a series of quantitative and qualitative criteria to target funds in order to identify those eligible for investment. Based on this investment universe, the management company should identify the funds to be monitored on an ongoing basis via regular contacts, on-site visits, etc.;*
- *implementation of an appropriate mechanism for supervising market risks on the overall portfolio (monitoring position concentrations, leverage in terms of portfolio sensitivity, maximum/monthly loss indicators, stress scenarios), as well as specific risks, liquidity risks and legal risks;*
- *availability of suitable technical resources (databases) to track funds and fund performance;*
- *the methods used to market the fund, in particular to avoid improper or misleading advertising".*

This approach was not concerned with assessing fund management strategy or the method used to select target investments. The aim was to allow the regulator to evaluate the way in which the management company planned to demonstrate *ex ante* that it could identify and manage the risks associated with this activity.

These programmes of operations are therefore an extremely useful way of ensuring that management companies can conduct a FoHF business in satisfactory conditions. They could also be a useful point of reference in establishing a European regulatory framework for FoHF activities.

- The regulator relies on management companies' ability to conduct the requisite due diligence using the appropriate resources, organisational structure and supervisory procedures in compliance with their specific programmes of operations

The number of FoHF programmes authorised by the AMF has been growing steadily since May 2004. This authorisation requirement does not therefore appear to have been an entry barrier for management companies looking to pursue this specific activity.

	2003	**2004**	**2005**	**2006**
Number of authorisations granted by the AMF *(total)*	11	60 [59]	67	73

Source: *AMF*

In practice, the AMF Board considered that management companies filing a specific programme of operations were able to prove that they would comply with the five conditions above on an ongoing basis and could justify this at any time during on-site visits and documentary audits by the regulator.

These programmes formalised the commitments made by management companies seeking to carry on a FoHF business, thus proving a useful tool for the regulator's ex post controls. They did not act as a barrier that might have prevented companies from entering the FoHF market on the basis of stringent requirements such as the need for adequate resources or a certain volume of assets under management. This situation is almost certainly due to the constructive dialogue that emerged between the AMF and management companies (especially entrepreneurial ones) preparing their programmes of operations.

Further clarification is doubtless needed as to how these programmes can provide a more secure framework for the minimum due diligence that the AMF requires from a management company when selecting an underlying hedge fund for investment.

Prior to this, the scope of these minimum due diligence procedures needs to be established. The working group agreed that any other such procedures should depend on the way the management company chooses to organise itself.

IV.2. Defining a secure framework for appropriate due diligence by FoHF managers

- Due diligence by FoHF managers is a key issue

Appropriate due diligence can be defined as a thorough investigation and in-depth analysis by the management company of a hedge fund's fundamental characteristics (legal structure, organisational quality, investment strategies) before an initial investment decision is made and on an ongoing basis thereafter.

[59] This figure reflects the approval by the AMF Board of management companies previously authorised to engage in FoHF activities and whose programmes of operations were approved in 2004.

Due diligence is designed to assess all the risks associated with an investment in this type of hedge fund, including fraud, operational risks and market risks.

Hedge funds differ from conventional investment funds in two ways:

- as mentioned above, hedge funds implement strategies with an atypical risk/return profile, and frequently have greater exposure to the risk of extreme losses;

- operational and fraud risks are much higher because the funds usually operate in a lightly regulated environment.

Onshore regulation of FoHFs should pay particular attention to preventing extreme risks, particularly fraud risk and operational risk. Final investors may indeed understand that they will have to bear any losses incurred because of poor investment decisions by the hedge fund. But at the same time they want an onshore framework for FoHF products that ensures the integrity and robustness of the underlying fund in which they have invested through an industry professional authorised by the regulator.

Due diligence should therefore aim to assess all the risks associated with investing in a hedge fund. All the members of the working group agreed that these procedures were an essential step in the process of hedge fund investing and should never be overlooked or considered as an unnecessary administrative constraint.

The working group also acknowledged that in-depth due diligence demanded significant resources, especially on-site supervision of the underlying hedge fund and investment manager or investment adviser, as the case may be.

- Initiatives taken by industry associations (AIMA) and analyses by the AMF's fellow regulators (e.g. FSA, SFC[60]) highlight the importance of due diligence by FoHF managers

IOSCO member regulators such as the FSA in the UK and Hong Kong's SFC increasingly acknowledge the importance of appropriate due diligence when a FoHF selects an underlying fund. Through discussions with an FSA representative, the working group learned that to achieve a more secure regulatory framework, the UK regulator placed particular importance on the following due diligence procedures:

- "prudent spread of risk";

- sound procedures for evaluating underlying hedge funds;

- the ability of the FoHF manager to meet investors' redemption requests;

- the ability of the fund of fund manager to exercise in-depth judgement when considering whether to apply side pocket arrangements [61];

- the ability of the FoHF to calculate its net asset value accurately.

In 2005, the Alternative Investment Management Association (AIMA) published a set of generic and illustrative due diligence questionnaires for the selection of managers and service providers.

One member of the working group, representing a rating agency specialised in the rating of investment selection procedures used by FoHFs, outlined the aspects of a due diligence framework that it rated positively as regards fund selection, portfolio construction, risk management, and management of liquidity constraints, valuation and reporting on underlying hedge funds.

[60] Hong Kong Securities and Futures Commission.

[61] With side pockets arrangements, fund managers can ring-fence certain long-term investments to ensure that when existing investors redeem from the hedge fund, they remain as investors in the side pocket until it is liquidated. The side pocket is liquidated at the appropriate time, independently of any subscriptions and redemptions. This mechanism prevents new investors from being exposed to the uncertainty associated with unstable and/or illiquid investments.

Among these best practices for a formal due diligence framework, the agency placed particular emphasis on ensuring that:

- the information provided by the underlying hedge fund is material;

- all participants in the fund of funds' decision-making process give a formal opinion, particularly as regards:
  - legal and administrative risks;
  - manager-specific risks;
  - risks associated with the investment strategy (level of risk, sensitivity, style drift, unstable historical risk profile, risk asymmetry);

- people in charge of operational and legal/administrative due diligence are independent and do not manage the fund;

- scores, ratings and written opinions are systematically documented and catalogued;

- the evaluation criteria can be easily identified and assessed, and are applied consistently;

- the final decision on the eligibility of a given fund is taken collectively by a special committee whose meetings are minuted and which may have a right of veto;

- the opinion resulting from the due diligence must consider portfolio monitoring and construction issues as well as eligibility. An underlying fund considered to be "high risk" should be monitored more frequently and more aggressively. The size of the portfolio (scale of investments) should reflect these considerations, in addition to a more conventional risk analysis;

- any problems flagged, in particular a delay in notifying a change of manager, are monitored during the post-investment phase.

Regulators, professional associations and rating agencies specialised in rating FoHFs all underlined the importance of the due diligence performed by the manager of those funds.

To define the substance of FoHF due diligence, it is necessary to identify to what extent these procedures should be governed by principles-based regulations, and to what extent they should depend on the organisational structure chosen by the management company.

- Establishing a regulatory framework to prevent fraud risk and operational risk in underlying hedge funds

One of the risks specific to hedge funds is the risk of failure. A recent study[62] found that over the last ten years, despite a sevenfold increase in the number of hedge funds, the number of failures[63] as a percentage of the number of funds in operation remained stable at almost 0.3%, or three funds out of every 1,000 per year.

However in the majority of cases, the problems were caused by fraud or operational risks that could have been detected or prevented by improved oversight, asset segregation and the separation of operational responsibilities in the underlying hedge fund. In the United Kingdom for example, the FSA estimates that most of the hedge funds that collapse every year are victims of operational risk (fraud and/or inadequate resources or structural shortcomings) and that only 40% fail as a result of investment risk (market and/or management risk)[64]. Another study carried out in 2003[65] said that 50%

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[62] Edhec – "*Quantification of Hedge Fund Default Risk*", Edhec Risk and Asset Management Research Centre – January 2007.
[63] Failures as opposed to the closure of funds.
[64] Figure quoted by Patrick Stevenson from Atlas Capital Limited in his April 2007 Banque de France Financial Stability Review on hedge funds. See the section entitled "Funds of hedge funds: origins, role and future".
[65] Capco – *"Understanding and mitigating operational risk in hedge fund investing"*, A Capco White Paper by Stuart Feffer and Christopher Kundro, The Capital Markets Company, March 2003.

of hedge fund failures were the result of operational risks, partly arising from fraud and poor valuation of illiquid or complex assets held by the hedge fund.

The recent setbacks involving Bayou Capital and Amaranth hedge funds highlight the importance of this distinction between events arising from extreme risks, such as fraud or operational risk, and those caused by market risks associated with an inopportune investment strategy.

Bayou Capital is an example of fraud-related hedge fund failure. The fund had manipulated the prices of illiquid bonds with the help of its own brokerage, defrauding investors of more than USD 500 million. In contrast Amaranth, brought down by market risks and illiquidity, lost more than USD 6 billion from a single massive spread bet on energy futures, which went against the fund[66].

Regulators must make a specific response to these risks.

To manage fraud risk effectively, regulations must ensure that the FoHF manager addresses the key preventive measures properly when selecting and monitoring underlying funds. This is the main concern of the principles-based approach discussed in Part III.1 of this report, which aims to ensure that FoHFs have proprietary and enforceable rights over the assets of the underlying fund.

In contrast, the FoHF manager is free to determine the market risk taken by the fund, in accordance with its programme of operations filed with the AMF, which monitors the programme's application on an ongoing basis.

***- A principles-based regulatory approach relying on appropriate due diligence guidelines implies that management companies can justify their investment decisions* ex post**

Regulation should not lay down hard and fast rules for the organisation, resources and procedures to be implemented by a FoHF management company.

It should, however, establish a framework designed to ensure that management companies have conducted appropriate due diligence. This framework is described by the management company in its programme of operations filed with the AMF. However, in the new regulatory environment proposed by the working group, this fact needs to be insisted upon more explicitly. A number of group members pointed out that similar measures already existed within their management company.

In a principles-based regulatory approach, management companies must have the following in order to conduct appropriate due diligence:

- **a documented, traceable procedure for selecting hedge funds**. This should be based on a qualitative and quantitative analysis of the fund’s characteristics, allowing the management company to assess the legal and operational risks associated with the funds and with the entities involved in running them (financial managers, depositary, statutory auditor, registrar) as well as the risks arising from the investment strategies and financial instruments used;

- the **human and technical resources** to implement this procedure, allowing the company to identify the aforementioned risks **through a collective decision-making process**. The management company should therefore have a documented, traceable procedure for its investments, enabling it to:
    - identify changes in strategies, along with any anomalies or new risks arising on the underlying funds. Fund managers should make sure that the principles used to select eligible investments are always satisfied;
    - provide appropriate supervision of all operational and market risks associated with the underlying funds, particularly liquidity risk, which should be assessed in light of the funds' subscription and redemption rules;

[66] See inset no. 2 of this report.

- the **resources, procedures and organisational structure allowing the company to**:
  - deal with any anomalies identified when monitoring the selected hedge funds or implementing any other procedures;
  - take any necessary corrective action;
  - ensure that all procedures are traceable and have been catalogued.

IV.3. Ensuring that FoHF investments offer satisfactory liquidity while authorising the introduction of gate provisions under certain conditions

- Liquidity issues associated with FoHFs

Managing liquidity risk is a key challenge for FoHFs because they have much greater exposure to it than do conventional general-purpose funds. The net asset valuation periods and subscription and redemption rules applied by many hedge funds can lead to a significant mismatch between the liquidity they offer and the liquidity available with French FoHFs, which operate in a stricter regulatory environment.

For example, French FoHFs are required to calculate net asset value at least once a month, while the hedge funds in which they invest need report only an estimated value every month, with definitive net asset value calculations performed on a quarterly, half-yearly or even yearly basis.

Furthermore, hedge funds can impose extremely long redemption notice requirements, lock-up periods lasting one year or more, and partial settlements staggered over several weeks.

To allow FoHFs to adapt to these specific constraints, the regulator introduced specific rules for FoHF managers operating in France. These rules, amended in 2006[67], were designed to align subscription and redemption conditions with those applied by the underlying hedge funds.

FoHFs "transform" liquidity by offering investors the possibility of subscribing to the fund or redeeming their investments every month. This grants investors access to less liquid funds which may be subject to lock-ups, and exposes the fund to a specific risk that must be managed appropriately.

The AMF has reiterated on many occasions that managing the liquidity of ARIA FoHFs is an integral part of financial management and that the management company is responsible for setting subscription and redemption rules, net asset value calculation periods, and notice requirements in a manner consistent with the overall liquidity of the fund and the type of investors to which it will be marketed.

However, a number of management companies informed the AMF in 2006 that their hedge fund investments had become less liquid, with longer notice requirements or less frequent net asset value calculations.

Some industry professionals considered that the current regulatory framework in France made it possible to deal with the increased liquidity risk arising from this situation. In contrast, others thought that new regulatory options should be introduced to manage liquidity risk under optimum conditions. Participants believed that liquidity risk management policies should be designed first and foremost to protect investors whose money remained in the fund, rather than investors who were redeeming.

The working group took up this issue, and in line with the responses to its consultation, agreed to support the introduction of gate provisions under certain conditions.

[67] Since the May 2006 decree, mandatory notice requirements for subscriptions or redemptions, applicable to ARIA funds only, cover a maximum of 60 days between the order centralisation date and the date on which the depositary delivers units/shares or settles redemptions. This maximum notice period applies only if the fund is not valued on a daily basis.

- Advantages of setting up a gate provision under certain conditions

Gates allow management companies to cap the amount of capital that can be withdrawn from a fund at each scheduled redemption date, with residual redemptions being postponed to the subsequent net asset value calculation(s) on a proportionate basis.

In practice, gates can be used in a number of ways. They may be calculated for each investor and the amount of his/her redemption order (this would mean identifying every single investor, which is hard to do if the fund is widely distributed), or globally on the basis of the fund's net assets. The percentage applied is usually between 5% and 20% of assets. Gates can therefore restrict the liquidity of the fund by spreading redemptions over time.

Gates are often used by the foreign investment funds in which French funds invest. The mechanism affords medium-term protection of the asset value of a fund invested in illiquid assets that are subject to abnormal market movements at a given time[68]. It keeps the fund from having to sell off its assets at fire-sale prices, which is clearly disadvantageous to its investors. In the countries where they exist. gate provisions are used only rarely and under strict conditions, unlike current mechanisms, such as notice requirements and systematic "punitive" redemption charges.

Investors are informed beforehand of any existing gate provisions by a detailed disclosure in the fund prospectus and, possibly, a note on the subscription form. By accepting the terms under which the provision is triggered, they are bound by rules limiting or deferring their chances of redeeming a percentage of their investment. However, they may benefit from more flexible conditions than those normally applicable (long notice periods, redemption charges, etc.) during the "normal life" of a fund.

- Improper use of gate provisions can generate risk

Because gates can present certain risks, clients should be "educated" or at least appropriately informed about them, and management companies should supervise the situations in which they are used.

If gate provisions are inadequately explained or used improperly, investors may be overly wary of funds that use these mechanisms, and those funds may overweight the illiquidity risks attaching to the units of the funds in which they have invested. Some management companies may also be tempted to use gate provisions not as a safety mechanism in one-off situations but as a daily tool for managing liquidity. This would further discourage investors.

Gates should be applied in exceptional situations only to avoid ruining the reputation of the fund and its manager. The conditions for implementing gates should aim to prevent their improper use and should be established at the highest level of the management company. Funds should provide full disclosure to investors whenever gates are in use.

In its response to the consultation, AFG recommended that to prevent excessive use of gate provisions, funds should be required to inform the regulator and investors whenever the provision has been implemented. The time period for redeeming the remaining investment should also be clearly indicated in the fund prospectus.

The working group agrees that certain conditions should apply to the use of a gate mechanism.

[68] However, gates would be less relevant for funds invested in more than 30 underlying funds, each having different liquidity rules with mandatory and attractive notice requirements.

- Conditions in which the introduction of a gate provision is acceptable

The working group recommends introducing a gate provision subject to certain conditions. The decision of whether to include a gate would be left to the discretion of the management company, which remains responsible for redeeming fund units in under the terms and conditions set out in the prospectus.

This mechanism would be used to manage exceptional situations alongside ongoing supervision of the FoHF's liquidity. Liquidity would be supervised on the basis of a liquidity schedule for French FoHFs, which is closely monitored as part of their duties by the financial management team at the management company.

Investors should be clearly informed that gate provisions exist when they invest in a fund. If the gate is implemented, they should receive clear information in a timely manner.

The decision to implement the gate will be taken on a collective basis by the management company and notified to the depositary, statutory auditor and the AMF.

IV.4. Implementing effective external supervision of FoHF managers' due diligence

Due diligence should be subject to external supervision to ensure that it is conducted in compliance with applicable regulations. The depositary and the statutory auditor therefore play an important role in ensuring that the regulatory framework for FoHFs offers the appropriate safeguards.

The specific characteristics of the FoHF depositary function can be examined from three angles: safekeeping of assets, control of the legality of the management company decisions, and liability management. The working group looked in particular at these first two roles, and put forward two types of recommendations.

Concerning the safekeeping of FoHF assets, consisting of units in underlying funds often domiciled offshore, one member of the working group outlined the practical difficulties faced by the depositary in its dealing with the registrar when carrying out due diligence ahead of an initial investment in an offshore fund.

Accordingly, the members of the working group agreed that as part of its pre-investment due diligence on the underlying fund, the FoHF manager should ensure that the registrar meets the proper standard. The manager should also make sure that the registrar will provide all the information needed by the depositary to proceed with subscriptions, to account for them and for subsequent corporate actions, to carry out controls, and to register positions[69].

In accordance with a principles-based regulatory approach recommended by the working group, the depositary should ensure that the management company performed due diligence in a consistent manner before investing in a fund. The depositary’s supervision would fall within its broader duty of ensuring that decisions made by the collective investment scheme are lawful.

Statutory auditors currently use a variety of practices to control FoHFs. However, in-depth tests are carried out on:

- the compliance and ongoing application of procedures verifying the criteria used to select eligible foreign non-UCITS held directly through a contractual arrangement;

- the book entry methods used by the depositary to record hedge funds;

- the specific methods used to price the funds and reconcile estimated and actual net asset values;

[69] Pursuant to Articles 333-1 *et seq*. of the AMF’s General Regulation.

- compliance with information set out in the prospectus specifically for FoHFs (maximum percentage exposure to underlying hedge funds and alternative investment strategies, subscription and redemption conditions [notice requirement], valuation periods);

- the liquidity of the underlying funds relative to the FoHF's ability to meet redemption requests;

- existing arrangements for monitoring the risk indicators identified in the prospectus.

In considering whether the quality of supervision by statutory auditors would be impaired by new principles-based regulations such as those recommended by the working group, an initial analysis suggests that the overall security of the system would not be affected, as auditors would continue to perform critical reviews. The new regulatory framework is, however, likely to result in stricter requirements on professional experience for the auditors concerned.

The key issue is actually the general approach adopted by auditors in reviewing and certifying the accounts of collective investment schemes, as each audit firm currently appears to apply different procedures and tests. The specific nature of FoHFs calls for specific audit procedures. The audit profession is currently pursuing an initiative with the help of specialised technical committees aimed at achieving greater convergence in industry practices. This initiative should certainly be encouraged.

Acknowledging the critical role of supervision by depositaries and statutory auditors in providing a secure framework for ARIA III funds marketed to retail investors, the working group recommends that:

- as part of their due diligence procedures, FoHF managers should ensure firstly that the registrar meets the proper standard and secondly that it supplies all the information needed for the depositary so that the latter can proceed with subscriptions, account for them and for subsequent corporate actions, carry out controls, and register positions;

- the FoHF grants the depositary access to information allowing it to verify that due diligence has been carried out and that hedge fund selection procedures have been complied with;

- the scope and extent of the external controls carried out by statutory auditors on FoHFs are based on professional best practice.

Conclusion

In this report, the working group has set out precise, balanced recommendations aimed at improving France's regulatory framework for FoHFs and ensuring that this already buoyant business will continue to develop.

Starting from a body of regulations that have so far proved fit for the purpose of investor protection, the working group endeavoured to strike the right balance between ensuring an appropriate level of product-related rules and creating a solid framework within which well organised management companies can perform appropriate due diligence.

These efforts are in keeping with the international initiatives now underway in the field of alternative investment and the group is therefore calling for the creation of a European FoHF vehicle. It would also like its recommendations to serve as a basis for the discussions to be held through IOSCO and at European level.

The success of the ambitious approach outlined in this report hinges on two fundamental considerations:

- The quid pro quo of establishing an appropriate rule framework for ARIA III funds, underpinned by a principles-based approach, is that French FoHF managers must be able to justify their investment decisions on an ex post basis. More generally, revisiting the constraints on ex post authorisation of collective investment products implies, in return, that management companies accept greater responsibility for organising their resources, procedures and controls within a framework that will still be regulation-driven. This approach is consistent with the new stance adopted the AMF as part of its Better Regulation policy[70];

- Going forward, the success of FoHFs will depend greatly on the appetite of institutional investors for this type of product. Wholesale investors can be a major force for market discipline, which could spread throughout the FoHF industry and generate positive externalities that would benefit the entire investment community. This means that the regulations applicable to institutional investors must be modified in the near future. At present, financial products exposed to similar asset classes or pursuing similar investment strategies are faced with different regulatory constraints, which distorts competition. In the view of the working group, these distortions are good reason for its proposals to establish a new framework for developing FoHF business.

Adopting this new approach is also a challenge for the AMF, which will have to adapt its procedures and supervisory tools to deal with a situation in which market participants have much greater responsibility.

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[70] See article entitled "La responsabilité des sociétés de gestion dans la détermination de l'éligibilité des actifs pour l'investissement par des OPCVM » in the AMF monthly review No. 35, April 2007.

Annex 1

Members of the working group
on funds of hedge funds, chaired by

Philippe Adhémar,
Member of the AMF Board
Chairman of the Consultative Commission
on Individual and Collective Asset Management

Rapporteur

Cyrille Stevant	**AMF** Senior Executive Officer Regulation Policy and International Affairs Division Secretary, IOSCO Standing Committee 5 on Asset Management (SC5)

Secretary

Diane Hamilton	**AMF** Senior Executive Officer Regulation Policy and International Affairs Division

Members

Jean-Philippe Ballin	**CACEIS Bank** Head of Trustee Services Compliance Division
Christian Bartholin	**HDF Finance** Managing Director French representative, Alternative Investment Management Association (AIMA)
Emmanuel Courant	Edmond de Rothschild Multi Management Deputy Chief Executive
Olivier Davanne	**DPA Invest** Partner Member, AMF Scientific Advisory Board
Michel Degiovanni	**Matmut** Deputy CEO, Finance Association Françaises des Institutional investors (Af2i) Chairman
Alain Dubois	**Lyxor Asset Management** Chairman of the Executive Board

	Member, European Commission expert group on hedge funds (July 2006)
Olivier Eon	**TestéPourVous** Editorial and Methods Manager Member, Consultative Commission on Small Investors and Minority Shareholders
Philippe Faure	**Banque de France** Deputy Head of Market Relations (General Directorate of Operations)
Bertrand Gibeau	**Association Française de Gestion**
Anne Landier-Juglar	**CACEIS Investor Services** Compliance Director
Philippe Lestel	**Alteram** Legal Director
Luc Martin	**Crédit Agricole Asset Management Alternative Investment** Director, Asset Management
Aymeric Poizot	**FitchRatings** Senior Director, CFA
Alain Reinhold	**ADI Alternative Investments** Executive Director Member, European Commission expert group on hedge funds (July 2006)
Etienne Rouzeau	**AGF Alternative Management** Director, Allocation and Risk
Patrick Sellam	**Cabinet Patrick Sellam** Auditor Member, Consultative Commission on Individual and Collective Asset Management
Jérôme Teiletche	**Société Générale Asset Management** Senior Quantitative Analyst
Benoît Vesco	**Meeschaert Family Office** Director, Fixed Income Investing
Alain Zaquin	**EIM France SA** Chairman
Paul Zariffa	**Société Générale Asset Management** Head of Legal Affairs for Alternative Investments

The group also benefited from the input and insights offered by AMF staff members who took part in it proceedings.

Pauline Leclerc-Glorieux	Head of Department Investment Services Providers and Products
Marguerite Yates	Head of Department Supervision of Investment Services Providers and Market Infrastructures
Catherine Balencon	Deputy Head of Department Supervision of Investment Services Providers and Market Infrastructures
Bertrand Merveille	Executive Officer Investment Services Providers and Products
Sonia Cattarinussi	Executive Officer Legal Affairs

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Annex 2

Persons presenting testimony to the working group

● At the meeting on 9 May 2007 concerning international initiatives in the field of hedge funds:

- **Dan Waters**, member representing the Financial Services Authority (FSA) on IOSCO Standing Committee 5 on Asset Management (SC5), FSA's Director of Retail Policy and Asset Management Sector Leader

- **Frank Dornseifer**, member representing BaFin on IOSCO Standing Committee 5 on Asset Management (SC5), Referent/Consultant, BaFin, and **Dr. Hener**, consultant to the hedge fund unit of BaFin

- **Hubert Reynier**, Managing Director, AMF; Director, Regulation Policy and International Affairs Division, chair of IOSCO Standing Committee 5 on Asset Management (SC5)

- **Niall Bohan**, Head of Unit 4, Asset Management, European Commission

● At the meeting of 20 June 2007 concerning an overview of the hedge fund industry in France and Europe:

- **Sophie Van Straelen**, founder and managing director, Asterias (education, fund data and market access for the hedge fund industry)

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Annex 3

13 regulatory criteria for the eligibility of underlying funds

Article 411-34, AMG General Regulation

Investment funds as defined in Article R. 214-5 of the Financial and Monetary Code shall meet the following criteria at all times :

1° The units or shares in the fund shall be transferable by book entry or by physical delivery in a central register of fund holders; this legal transferability shall not be overruled by any authorisation clauses.

2° The unit holders and shareholders in the fund shall have equal rights within each category or class of units of capital or assets. Different rights with regard to operating and management fees and subscription and redemption terms shall not override these equal rights as long as such rights do not involve the capital or assets;

3° The fund shall have rights and obligations arising from the existence of its own assets and liabilities;

4° The responsibility for custody of the fund's assets shall be entrusted to one or more companies, which are separate from the portfolio management company, regulated for this purpose and identified in the prospectus;

5° Custody of the funds assets shall be provided separately from the custody of the custodian's own assets and those of its agents;

6° The fund's assets may be reused by the custodian or its agents, and by any person holding a claim against the collective investment scheme, if the claim arises from temporary transfers of securities or the use of financial instruments held by the collective investment scheme, or a collateralisation transaction as stipulated in the third paragraph of point I of Article R. 214-12 of the Financial and Monetary Code, if the collective investment scheme provides the collateral under all the following conditions:

a) The reuse is subject to the fund's explicit consent and appropriate disclosure to holders;
b) The fund is entitled to take back the financial instruments used or equivalent financial instruments at any time;

7° The entity that manages the fund or provides investment advice is subject to the supervision of an authority that regulates such activities and with which the entity is registered; "Compliance with this requirement shall be assessed at the time when the investment in the fund is undertaken.";

8° The regulations in the fund's home country stipulate that the fund's annual financial statements must be certified by a statutory auditor. Failing that, the fund's prospectus stipulates that a statutory auditor carries out an equivalent audit of the fund's annual financial statements;

9° The liability of the fund's unit holders or shareholders is limited to the amount of their investment;

10° The fund produces a prospectus that describes its management rules and constitutional rules;

11° The fund produces management reports at least once a quarter with material information about developments in its portfolio and its results;

12° The fund provides all its unit holders or shareholders with a net asset value or an estimated value, as defined in Article 411-47, at least once a month;

13° The fund's home country is not on the list of countries where the legislation is not recognised as adequate or where practices are not deemed to be in compliance with the provisions on combating money laundering and terrorist financing by the international body for consultations and coordination with regard to combating money laundering and terrorist financing.

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Annex 4

Thresholds for investing in funds of hedge funds in Europe

(Source: Asterias)

Country	Regulated product	Retail investors	Minimum investment
United Kingdom	Qualified Investor Scheme	No	None
	Fund of hedge funds	Not yet…	
Ireland	Professional Investor Fund	No	€125,000
	Qualifying Investor Fund		€250,000
	Fund of hedge funds	Yes	None
Italy	*Fondi speculativi* Speculative fund	No	€500,000
	Fund of hedge funds		
France	*OPCVM à règles d'investment allégées (ARIA)*	Yes	€125,000
	OPCVM contractuels		€250,000
	OPCVM de fonds alternatifs (fund of hedge funds)		€10,000
Luxembourg	Undertakings for collective investment pursuing alternative investment strategies	Yes	None
Germany	*Sondervermögen mit zusätzlichen Risiken*	No, but	None
	Fund of hedge funds	Yes	
Portugal	*Fundo Especial de Investimento*	Yes	€15,000
Spain	IIC de Inversión libre	No	€50,000
	IIC de IIC de Inversión Libre (fund of hedge funds)	Yes	None

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Annex 5

Summary of the AMF's targeted consultation on the French regulatory framework for funds of hedge funds and ways to improve it.

The AMF organised a consultation on funds of hedge funds (FoHFs) in April and May 2007, targeting it on the principal market stakeholders. The aim was to canvass a broad spectrum of views on the state of the regulatory framework for FoHFs in France and on ways of improving it. The consultation was conducted in parallel with the activities of a working group composed of market practitioners and representatives of individual investors. The group, chaired by Philippe Adhémar, a member of the AMF Board and Chairman of the Consultative Commission on Individual and Collective Asset Management, took the findings of the consultation into consideration.

In April 2007, the AMF sent a consultation paper to 70 investment management companies having a programme of activities for FoHFs, as well as to the main industry associations in the French markets and the members of the AMF Scientific Advisory Board. The paper described the key elements of the French regulatory framework, the principal characteristics of the domestic market, and the main international initiatives in the FoHF industry.

It also asked a series of questions about the relevance of the AMF's classification of *OPCVM de fonds alternatifs* (funds of hedge funds), the disclosure requirements and rules for marketing this type of fund to retail investors (especially funds organised as ARIA III funds with streamlined investment rules), the make-up of the special programme of operations for FoHFs and oversight arrangements, and FoHF managers' due diligence requirements and their problems in managing liquidity. The consultation paper also addressed the issue of whether the 13 eligibility criteria for underlying finds were relevant.

The consultation elicited responses from nine investment management companies (Altigefi, Dexia AM, Exane Asset Management, Société Parisienne de Gestion, Harewood Asset Management, IXIS Private Capital Management, HDF Finance, GEA Multigestion alternative, Lyxor Asset Management), four industry associations (AFG[71], FBF[72], AFTI[73], Af2i[74], AFEI[75], et FFSA[76]) and one member of the AMF Scientific Advisory Board (Marc-Olivier Strauss-Kahn, Director General, Economics and International Relations Directorate General at the Banque de France).

[71] Association Française de la Gestion Financière / French asset management association
[72] Fédération Bancaire Française / French banking federation
[73] Association Française des Professionnels des Titres / French association of securities professionals
[74] Association Française des Investisseurs Institutionnels / French institutional investors association
[75] Association Française des Entreprises d'Investment / French association of investment firms
[76] Fédération Française des Sociétés d'Assurance / French federation of insurance companies

1. French regulatory framework and international context for funds of hedge funds

QUESTION 1 IN THE CONSULTATION PAPER

Regarding exposure to hedge funds, do you think that there any possibilities for arbitrage between funds of hedge funds (FOHFs) classified as *OPCVM de fonds alternatifs* (especially those organised as ARIA FoHFs) and other products? If so, which products? How do you assess these arbitrages? Are they warranted from the point of view of investor protection?

Do you agree with the approach of testing the competitive nature of the French framework for FoHFs?

Do you support the principle of drawing up European standards for FoHFs with a view to making it easier to market these funds at European level?

How do you assess the risk that creating a regime and European passport for FoHFs might interfere with the amended UCITS Directive? Is there not a risk of seriously undermining the incentive for asset managers to comply with the amended UCITS Directive if there is a possibility that a European passport might be offered to investment funds with different requirements? How can this issue be addressed (thresholds for purchasing the product, notification procedure that derogates from the standard procedure, etc.)?

The AMF's approach of conducting an ex post assessment of its FoHF regulations was warmly welcomed.

Two of the contributors considered that the assessment should seek specifically to put the French industry in an advantageous position relative to its European competitors while remaining attentive to the need to protect potential clients for these products, who in many cases are likely to be non-professional investors.

In the opinion of AFEI, the FoHF industry is almost the only one willing to pay a fair price for the value added generated by the services it receives. AFEI also expressed regret that Paris had been slow to specialise in this area, particularly compared with the City of London, where the hedge fund industry created a bandwagon effect at a very early stage. The delay is especially regrettable since the FoHFs managed out of London rely heavily on French professionals.

Most of the responses noted that individual investors seeking to diversify their financial assets while avoiding the effects of excessive regulation (high minimum investment requirement, diversification rules for ARIA funds, etc.). can easily arbitrage between the products referred to in the consultation paper and AMF-regulated FoHFs.

Respondents also mentioned the impact of the Eligible Assets Directive on the UCITS marketed to retail investors, as well as the negative consequences – as perceived by FoHF practitioners – of the possibility that hedge fund derivatives may be eligible for UCITS investments. There is broad agreement on the increasing difficulty of tracing a clear-cut border between the "conventional" investment management universe and hedge funds. Accordingly, FoHFs must be seen from the overarching perspective of investment management.

One of the respondents stressed that regulatory arbitrage between products is also attributable to the fact that the regulations applicable to wholesale investors make it hard, if not impossible, to invest in ARIA funds.

All the respondents [77] support a regulated European regime for FoHFs in order to establish a level playing field between products that use fairly similar investment strategies and that, to a greater or lesser extent, are now being distributed to retail investors. The FBF, for example, suggested introducing private placements, both for securities and for funds. This would make it possible to place securities without first having to prepare a prospectus, provided this was done solely with "institutional" investors. The scope of this constituency would have

[77] With the notable exception of the FBF, which considers it too early to create a European standard for hedge funds. The FBF believes it would be more useful to ensure that the legislation does not hinder the possibility of setting up hedge funds that can invest in a broad range of assets, including derivatives.

to be defined but it could cover the professional investors defined in the Markets in Financial Instruments Directive.

The majority of respondents considered that a uniform European framework and common standards should be drawn up for FoHFs, and that these funds should be passportable within European. Such a framework would not have an adverse effect on UCITS in their present form.

However, doubts were expressed about the speed with which a European system of this sort could be put in place. For that reason, rapid implementation of a European private placement regime would be a fruitful avenue of advance, more so than introducing mutual recognition procedures between European regulatory authorities in the near term.

2. APPROPRIATE CONDITIONS FOR CLASSIFICATION, INFORMATION AND RETAIL MARKETING OF FUNDS INVESTING IN HEDGE FUNDS

QUESTION 2 IN THE CONSULTATION PAPER

Do you find the *OPCVM de fonds alternatifs* classification of AMF-regulated FoHFs, as defined in Article 29 of Instruction 2005-02, to be appropriate? Why? How could it be improved? Is the *ARIA de fonds alternatifs* classification appropriate? Why? How could it be improved?

Is the information supplied to investors in funds classified as *OPCVM de fonds alternatifs*, especially ARIA FoHFs satisfactory?

How would it be possible to improve and/or simplify the information supplied to investors in ARIA FoHFs as regards the ***risks*** of the underlying funds and the overall ***risk*** of ARIA FoHFs?

In terms of the ***fees and charges*** paid by investors, are there any issues specific to ARIA FoHFs? If so, what are they and how can they be dealt with appropriately?

Do you feel that, under current regulations, **the minimum frequency for publishing net asset values** is suitable? Why?

Is the **EUR 10,000** threshold for investing in an ARIA FoHFs appropriate? State the precise reasons for your position.

If this threshold were to be amended or abolished, how would it be possible to avoid the mis-selling of ARIA FoHFs to retail investors?

- The respondents are divided on classification issues. Some consider that the AMF's *OPCVM de fonds alternatifs* classification is appropriate while others are unhappy with the confusion caused by having a single classification. In particular, this situation causes problems of understanding and communication for rating agencies, reflected in the rankings they publish.

One response also pointed out that the current classification restricts the investments that some retail investors can make in ARIA III funds. The respondent therefore recommended that ARIA III funds and non-leveraged funds be placed in categories that allow institutional investors to increase the amounts they invest. It also suggested raising the 10% threshold for non-ARIA funds to 15% or 20% so that "conventional" funds could use alternative investment techniques.

- Regarding ARIA III funds, many respondents find that the expression "*à règles d'investissement allégées*" (with streamlined investment rules) is misleading. The risk spreading rules are actually the same as those for UCITS and may be even more restrictive than for a UCITS of UCITS. Furthermore, the meaning of the name "ARIA" cannot be intuited. For that reason, it does not necessarily draw the investor's attention to the nature of the product or its degree of risk because it bears no relation to the term "*gestion alternative*" that consumers know as a generic expression for alternative investing. The name is also a handicap to cross-border distribution. It is hard to transpose into English, the lingua franca of the hedge fund industry and, more importantly, the language used by French investment managers to promote their products outside France.

Some of the responses therefore recommended that the AMF classification should include a reference to the traditional asset classes in which ARIA III funds invest. This would allow rating agencies to place these funds into the proper asset classes whereas, at present, they are lumped together in the catch-all category of "*gestion alternative*", which mixes asset classes, investment objectives and management techniques. As a result the information supplied to wholesale and retail investors – both in France and especially abroad – is indecipherable.
Defining a harmonised European framework for FoHFs would thus provide an opportunity to adopt a naming system that is more in keeping with the one commonly used in international finance. This could also be a pre-condition for allowing European asset managers to compete with their counterparts in other parts of the world, especially the USA.

- The information provided to investors in the prospectus seems to be satisfactory but could be simplified and harmonised from one prospectus to another. One portfolio management company suggested mandatory disclosure, at least partially, of the main asset positions when the fund is set up. This would provide greater transparency for investors, particularly with regard to the concentration of investments. In addition, one respondent suggested that key information about investor risks, especially liquidity risk, should be repeated on the subscription form.

- Regarding expenses, full disclosure of the costs borne by underlying funds seems neither relevant nor realistic from an operational standpoint . Final investors should receive precise, intelligible information about the fees and charges (front end load, exit fee, fixed and variable expenses to which the portfolio may be exposed), but it would be inadvisable to go any further. That said, one portfolio management company suggested providing information about the average level or range of the fixed and variable management fees of the underlying funds used by FoHFs. Af2i considers that Part B of the prospectus meets investors' needs.

- There were few responses to the question about periodic publication of net asset values. One portfolio management company said that the question was still open as to whether a degree of flexibility was desirable. The respondent said that while it was important to provide investors with estimated portfolio values at least once a month, the managers also should be allowed to choose whether greater flexibility was needed in terms of frequency of subscriptions and redemptions. That leeway is especially important for investments in which liquidity is inherently limited, e.g. asset based lending.

From the investor's viewpoint, Af2i said that it wanted net asset values to be published more frequently but that, realistically, the calculation could be made on a monthly basis only since the underlying funds are valued once a month. For Af2i, provisional net asset value seems to be a good yardstick for checking and monitoring investments properly.

- The responses to the question about the subscription threshold highlighted the differences in the way that various sophisticated investment intended for retail investors are treated. Some respondents pointed to the recent significant growth in the volume of structured products, especially those distributed through banking networks. Some of these products are particularly complex and hard to understand. They may involve major, specific risks of non-achievement of performance targets or, in some cases, of capital losses. Accordingly, investors need special financial skills and/or, failing this, a sufficiently broad capital base to ensure that such products account for only a limited share of their total assets.

It is therefore vital that the distributors who deal with investors should be able to understand the complex products they are selling and to explain them in detail. Some respondents said that the current EUR 10,000 threshold was inappropriate in view of the complex nature of the products being offered. Others preferred to highlight the uneven competitive playing field, implying that the threshold should be lowered or possibly abolished. One respondent even suggested lowering the threshold to EUR 1,000.

More generally, the FBF considers that investor protection should not hinge on whether an asset is eligible for a hedge fund investment but on distribution criteria and the distinction between wholesale and retail investors.

3. AUTHORISATION OF MARKET PARTICIPANTS: THE SPECIAL PROGRAMME OF OPERATIONS FOR FUNDS OF HEDGE FUNDS AND THE METHODS OF CONTROLLING IT

QUESTION 3 IN THE CONSULTATION PAPER

What is your assessment of the FoHF **programmes** submitted to the AMF for authorisation? In which areas could they be improved or trimmed down?

Do you agree with the conclusions the AMF has drawn from the failure of Amaranth? Explain the reasons for your position.

Should the AMF amend or ease its policy on delegation? Why and how?

1. The question about the assessment of programmes of operations elicited only two comments.

According to one respondent, the information requirement for companies that already have a general authorisation should be confined to FoHF management per se and should not deal with general issues. The most important aspects of the programme of operations that warrant scrutiny are:

- the investment process (choice of strategies and fund managers);
- process for analysing and managing financial, legal and operational risk;
- pre-investment and post-investment due diligence;
- human, technical and financial resources.

The respondents recommended more stringent requirements in terms of resources. One contributor said it doubted that the 70 management companies with AMF-approved FoHF programmes of operations actually had all the human, technical and financial resources needed to carry on that business under optimum conditions. The same contributor believes there is a physical limit to the number of funds an analyst is able to follow, or to oversee once a fund has been included in the selection, and that this limit should be taken into account in the programme of operations.

Another respondent said that although extensive resources were needed to prepare and update a programme of operations, the procedures resulting from that programme also need to be updated, and this is a very cumbersome process. For that reason, a general update should be scheduled once a year in order to avoid recurring revisions. The respondent noted that the burden was even heavier for management companies which, in order to carry on their hedge fund business, need an authorisation for direct management, for indirect management or, in some cases, the programme of operations for derivatives. If a uniform framework were to emerge at European level, French programmes of operations could serve as a template for the European programme. At the same time, however, it should be possible for French programmes to be scaled down, giving greater responsibility to management companies. This in turn would lead to changes in supervisory authorities' oversight methods.

One industry association proposed that FoHF programmes subject to AMF authorisation should outline the management company' approach to prior due diligence so that the depositary can perform its function as custodian of hedge fund assets. Accordingly, FoHF programmes should cover finding out about the resources and operating methods of all those involved in the fund. Among other things, this would take the form of a new-business file for the commencement of operations with the registrar. The purpose of this file would also be to ascertain that the registrar is able to pass on all necessary information to depositary within a normal timeframe.

2. The responses to the question about delegation were more detailed, with respondents calling for greater freedom for management companies that delegate. They also stressed the strictness of AMF policy in this regard.

AFG, along with other management companies, is very much in favour of allowing management companies to delegate, either partly or in full, the financial management of funds, whether general-purpose or not (e.g. ARIA funds). In the interest of shareholders/unitholders, it is normal that a portfolio management company should be able to benefit from skills that it may not necessarily have in-house in a particular area.

According to AFG, a portfolio management company with a FoHF programme of operations should be entitled to delegate due diligence procedures to specialists, particularly when analysing the essentially legal issues arising from funds established in off-shore jurisdictions.

Likewise, AFG considers that a portfolio management company that does not have a FoHF programme of operations ought to be able to delegate its financial management fully or partially to a portfolio management company that does have such an authorisation.

In terms of jurisdiction, the delegating company must be in a position firstly to monitor the delegatee, i.e. to ensure at all times that it is managing the fund in accordance with the terms of the delegation and that the investment ratios and other rules applicable to the fund or the mandate are being respected (especially with regard to risk limits), and secondly to monitor the fund's performance over time. In AFG's view, although the delegating company must implement procedures for monitoring the delegatee and ensuring its resources are fit for purpose, it should not need to ask the AMF to approve a FoHF programme of operations.

However, the AFG adopts a much more cautious stance in cases where the delegatee is a foreign portfolio management company with no equity links to the delegating company.

By contrast, another respondent took a more finely shaded position. It said that the requirement to be able to understand and monitor the delegatee's business at all times was still relevant, but it suggested that the programme of operations for supervision should be less burdensome than a FoHF programme.

In conclusion, AFEI suggested that the rules could be adjusted depending on the extent to which the delegation arrangement is transparent to the client. Where the client is totally unaware that the activity has been delegated, the AMF's strict policy is appropriate. However, AFEI believes that the regime could be relaxed if the client receives more information about the terms of the delegation agreement.

QUESTION 4 IN THE CONSULTATION PAPER

Do you see the need for a code of practice for the due diligence to be performed by FoHF managers when selecting and monitoring target funds? If so, on what priority areas should the code focus?

Should the AMF sanction infringements of the code? If so, in what way?

There is general agreement on the principle of a code of practice, but there are differing opinions as to its scope. Some respondents think it would be timely to implement a code of practice for due diligence, on the understanding that it would incorporate principles governing the eligibility of underlying funds.

However, the code should confine itself solely to establishing general principles. It should not impose standardised practices – particularly as regards due diligence – but should respect the organisational structure of each portfolio management company and the specialised characteristics of its environment. The possibility of imposing a due diligence format in the form of a questionnaire was ruled out.

One portfolio management company noted that the AIMA questionnaire, which seems quite exhaustive in terms of analysing risk spreading rules in a hedge fund, could be the ideal starting point for drawing up a code of practice.

Moreover, the code should:

- make it possible to eliminate all regulatory constraints on products, meaning that due diligence would be focused principally on the legal and organisational aspects of management companies;
- concentrate on standards for legal and operational risks but not financial risk – once again, because of the highly varied nature of hedge fund strategies – and not seek to codify investment research methods.

In addition, one portfolio management company said that insofar as a code of practice is based on general principles and standards, any infringements are apt to vary in importance or even to be subjective. Accordingly, provision should be made for different levels of "sanctions", possibly starting with a "warning" before any formal proceedings are set in train.

Another portfolio management company thinks it would be useful to define minimum knowledge requirements for carrying on an alternative investment business. To check whether those requirements are satisfied, managers and directors of management companies specialising in alternative investment strategies could be made to sit an examination. This would be equivalent to the Series licences in the USA, which are required for certain activities.

4. MANAGEMENT OF LIQUIDITY RISK BY FUND OF HEDGE FUNDS MANAGERS

QUESTION 5 IN THE CONSULTATION PAPER

In your view, are the regulations put in place by the AMF in association with the industry sufficient to ensure that liquidity risk is managed satisfactorily? If not, what changes should be made?

More generally, should changes be made to the procedures for subscribing and redeeming units of ARIA FoHFs? If so, why and how should those changes be made?

One respondent notes that some funds borrow cash to meet redemption requests and that, in certain cases, these liquidity requirements exceed the regulatory level of 10% or the limit stipulated in the fund prospectus. That said, the problem is not confined to hedge funds; it apparently stems from the terms and conditions of subscription/redemption and also from the resources implemented by the management company to manage the fund's liquidity.

The respondent therefore suggested that if a management company trades in illiquid markets, its programme of operations, or the authorisation request filed by the fund, should provide for a liquidity management mechanism to ensure, among other things, that subscriptions and redemptions proceed at an appropriate pace. The mechanism would include one or more scenarios for coping with a liquidity crisis as part of a framework negotiated at market-wide level. The framework should include provisions for:

- settlement freezes imposed by the liability manager and the depositary
- the procedure for implementing those freezes.

The existing liquidity mechanisms, such as notice requirements, rely heavily on the manual processing of redemptions, which generates additional costs and operational risk. Furthermore, all market participants are now concerned by this issue, namely Euroclear, investors' custody account keepers, and fund liability managers. Introducing new liquidity mechanisms, such as redemption gates (see below), would probably increase costs and operational risk. The respondent proposed that new processes should be put in place, managed at market level, to improve the competitive standing and security of the Paris financial centre.

Strong support was expressed, including by Af2i, for the introduction of redemption gates. A gate provision allows a fund to suspend redemptions if they account for a pre-determined percentage of its assets. The respondents considered that this mechanism would protect investors and help financial markets to function smoothly, for the following reasons:
- Unlike the current mechanisms (notice requirements, high exit fees), gates are implemented only exceptionally;
- With a gate, redemption requirements can be applied to a fraction of the underlying assets. This is a favourable situation for investors who want to redeem and who have the possibility to do so. If an exceptional event occurs and a gate is implemented, the investor can still redeem a portion of his order. The present situation, where gate provisions do not exist, is less favourable because there is a risk of an all-out redemption suspension. The gate mechanism avoids a total suspension, which is obviously high detrimental to investors;

- Gates mitigate the impact of large-scale redemptions on the fund's net asset value. This is an undeniable advantage for the investors who remain invested because the fund is not forced to sell off its assets at fire-sale prices.

In addition to the appropriate wording of the prospectus, the respondents also mentioned that funds could be required to notify the AMF if they implement a gate provision. In this case, all the circumstances leading up to this event would have to be suitably explained not only to the regulator but also to the statutory auditor. The terms and conditions for redeeming the remaining assets if a gate is implemented would be set out clearly beforehand in the prospectus.

One respondent suggested alternatives to gates, such as:
- longer redemption notice periods than those currently in place;
- lock-ups, either a "hard" lock-up, where investors have no right to redeem, or a "soft" lock-up, where they are entitled to redeem early but have to pay an additional redemption fee.

All these techniques should enable fund managers to control liquidity risk more effectively and ultimately protect final investors. But the one that received the strongest endorsement was the gate provision.

One contributor, responding to the first, more general question about managing liquidity risk, pointed to a competitive distortion that adversely affects French management companies. A mismatch between the liquidity of the underlying funds and the liquidity offered to investors prevents, or certainly hinders, FoHFs from accessing top-performing hedge funds. Access to the best performing funds and strategies often entails restrictive clauses governing liquidity. However some strategies, such as asset based lending, are inherently illiquid. Therefore the current framework is unfavourable to French funds because it requires them to be valued on a monthly basis. This, according to the respondent, distorts competition at European level.

5. MONITORING THE DUE DILIGENCE CONDUCTED BY MANAGEMENT COMPANIES

QUESTION 6 IN THE CONSULTATION PAPER

Do you think that the role and the scope of accountability of the depositary, the statutory auditor or compliance and internal control officer under AMF regulations on FoHFs are appropriate? Why? Should they evolve and, if so, how?

With regard to monitoring FoHFs managers, are there any other entities whose roles and accountabilities should be more clearly established?

This question elicited a sparse response, apart from one industry association, which described in detail the three key functions performed by the depositary, namely custody, control and establishment of liabilities.

Regarding custody, the respondent suggested that the position keeping activity needed to be clarified. Improvements should be made to the procedures for exchanging information between the management company and the depositary when the company chooses the registrar, and management companies should monitor equalisation shares more effectively.

On the subject of control, the respondent said that depositaries have so far been unable to carry out independent due diligence for a number of controls. For example, net asset value calculations and cascades of funds can be controlled only by reviewing the management company's procedures and due diligence.

Lastly, for liability establishment, the roles and accountabilities of the various participants should be defined more clearly, especially as regards equalisation shares.

6. 13 ELIGIBILITY CRITERIA FOR FOREIGN UNDERLYING FUNDS

QUESTION 7 IN THE CONSULTATION PAPER

Which of the eligibility criteria for underlying funds need a **clearer interpretation**? Why and in what way?

Which of the eligibility criteria for underlying funds should be **amended** in terms of **content**, without altering the degree of legal protection afforded to final investors? Why and in what way?

Do any other criteria need to be **added?**

More generally, after three years' experience, what conclusions can you draw about the relevance of the criteria? Have they hampered the development of any products that would have been appropriate for wider distribution? If so, which products?

Is the best way of supervising the possibility of investing in target funds to lay down a set of detailed criteria, or would it be better to pursue an approach based on broader principles? In the second case, which of these general principles should be adopted?

Which of these criteria are relevant to real estate collective investment schemes (OPCIs) investing in foreign funds? Why?

The question about the relevance of the AMF's 13 eligibility criteria for underlying funds gave rise to considerable comment. Respondents criticised the way that the regulator has formulated the criteria as well as the problems of interpreting them and putting them into practice. However, the comments regarding their intrinsic relevance were more balanced.

AFG said that the criteria, "graven in regulatory stone" by the AMF, are not always relevant and that is up to the managers and their teams to determine which funds to invest in. Instead of setting regulatory criteria *ex-ante*, the AMF should concentrate on the human and technical resources and the (independent) organisational structure that management companies should put in place for selecting underlying funds.

AFG recommends a principles-based approach, with each portfolio management company determining how it will implement the approach depending on its own organisation. This due diligence should be carried out by a team composed of risk managers, compliance and internal control officers, etc., that could have a real power of formal veto over planned or actual investments. Like the AFG, the FBF proposed that the regulator should concentrate on the human and technical resources and the (independent) organisational structure that management companies should put in place for selecting underlying funds rather than on laying down criteria.

The other respondents stressed the cumbersome administrative procedures involved when off-shore funds have to comply with the 13 criteria. Apparently, these highly restrictive procedures give French FoHFs a bad name because they are seen to involve too many regulations and too much red tape. This undermines the competitiveness of French funds of funds in general.

One respondent offered an alternative solution for tackling some of these problems. It suggested that the AMF should issue a document in English explaining the 13 criteria, which could be sent to off-shore funds. It also suggested that efforts should be made to harmonise regulations, thereby facilitating a comparative examination of the 13 criteria. According to the respondent, there is an overlap between the regulations of the AMF, the FSA, the SEC and other regulators. Accordingly, if an off-shore works with an FSA-regulated prime broker/ custodian, it would automatically be deemed to satisfy Criteria 5[78] and 6[79].

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[78] Criterion 5°: Custody of the funds assets shall be provided separately from the custody of the custodian's own assets and those of its agents.
[79] The fund's assets may be reused by the custodian or its agents, and by any person holding a claim against the collective investment scheme, if the claim arises from temporary transfers of securities or the use of financial instruments held by the collective investment scheme, or a collateralisation transaction as stipulated in the third paragraph of point I of Article R. 214-12

One portfolio management company suggested adding a principle concerning the conditions in which funds are valued.

With regard to the current criteria, all the respondents, bar one, said that Criterion 7 should be amended quickly, along with the grandfathering clause currently applicable to US funds. It beggars comprehension that managers should be prohibited from reinvesting in a fund they already hold in their portfolio. Furthermore, the concept of regulators "recognised" by the AMF needs clarification.

The only respondent that argued for maintaining Criterion 7 put forward four arguments. First, it seems illogical that a regulated fund could be invested in an unregulated fund. Second, Criterion 7 seems clear. Third, the requirement that the manager or investment advisor should be regulated ensures a minimum level of effective regulation. Last, all managers based in Europe are regulated. Accordingly, the portfolio management company wishing to keep Criterion 7 suggested maintaining it in full but removing its "cut-off" effect by means of an "other stocks" (*ratio poubelle*) with a threshold or 10% or even 20% of assets.

Still on the subject of Criterion 7[80], a portfolio management company proposed that a FoHF should be permitted to invest up to 25% of its assets in funds managed by managers that are not registered with a supervisory authority, on condition that no position in such a fund exceeds more than 5% of the assets of the investing fund. .

However, the questions relating to managers' compliance with the 13 criteria did not always elicit such harsh judgements as those discussed above. Some respondents said that the AMF's criteria were a necessary and elemental set of requirements for fund selection. They do not put French funds of funds in an unacceptably disadvantageous position. To illustrate that point, one portfolio management company stated that the percentage of funds eligible for its Luxembourg FoFs was 8.1% whereas these same target funds would be ineligible under French law on the grounds, inter alia, that funds deregistered with the SEC are not eligible in France.

Some respondents said they would welcome greater flexibility in the interpretation of Criteria 4[81], 5 and 6. Certain management companies have to systematically explain these criteria to off-shore funds, which rarely grasp the issues that they address.

AFTI considers that depositaries' second-level controls of compliance with the 13 criteria really depend on the quality of the due diligence done by the management companies and the formal expression thereof. In general, Criteria 5 and 6 are the hardest ones for depositaries to verify because they are based not on information available in the prospectus but on statements of compliance from the management companies of the target funds.

Moreover, depositaries have noticed major differences in management companies' methods and resources:
- some management companies perform due diligence on some of the criteria on an ex post basis, even if this means selling off their position if the criteria are not satisfied;
- other companies ask the target fund for a comfort letter guaranteeing that the 13 criteria have been met.

Depositaries cannot control the due diligence performed by management companies unless the regulatory framework is sufficiently precise. Accordingly, provision should be made to oblige the management company to provide or make available to the depositary the results of its controls of the entire process and, at the depositary's, request, to supply details of those controls.

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of the Financial and Monetary Code, if the collective investment scheme provides the collateral under all the following conditions:
a) The reuse is subject to the fund's explicit consent and appropriate disclosure to holders;;
b) The fund is entitled to take back the financial instruments used or equivalent financial instruments at any time.

[80] Criterion 7: The entity that manages the fund or provides investment advice is subject to the supervision of an authority that regulates such activities and with which the entity is registered; Compliance with this requirement shall be assessed at the time when the investment in the fund is undertaken.

[81] Criterion n°4°: The responsibility for custody of the fund's assets shall be entrusted to one or more companies, which are separate from the portfolio management company, regulated for this purpose and identified in the prospectus".

7. Miscellaneous

QUESTION 8 IN THE CONSULTATION PAPER

Which other aspects of French regulations on FoHFs should be examined by the AMF and the working group? Please explain why.

How should these additional aspects be addressed and, where appropriate, resolved by the AMF and the working group?

In AFG's view, the supervisory authorities responsible for institutional investors should be more closely involved in discussion and debate about the future of French regulations for FoHFs.

A portfolio management company suggested that throughout the launch period for an ARIA of hedge funds (e.g. three or six months), the fund should be allowed a degree of tolerance with regard to the risk spreading ratio or be permitted to adopt a more flexible ratio.

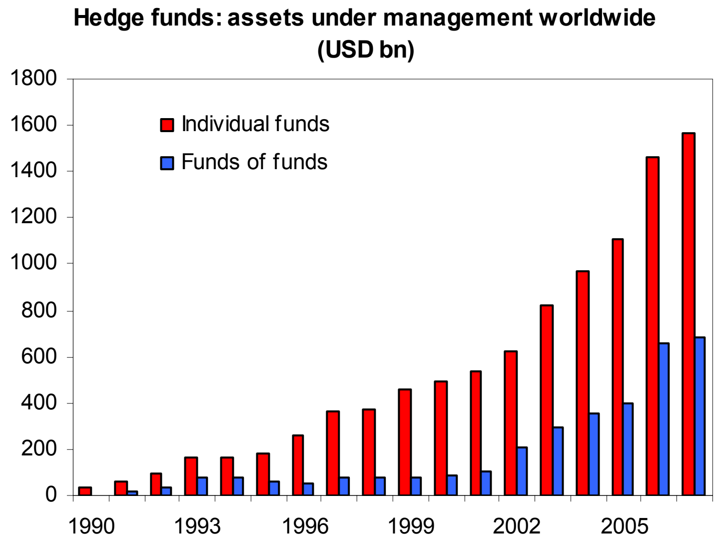
Annex 6

Taking Stock of ARIA Funds

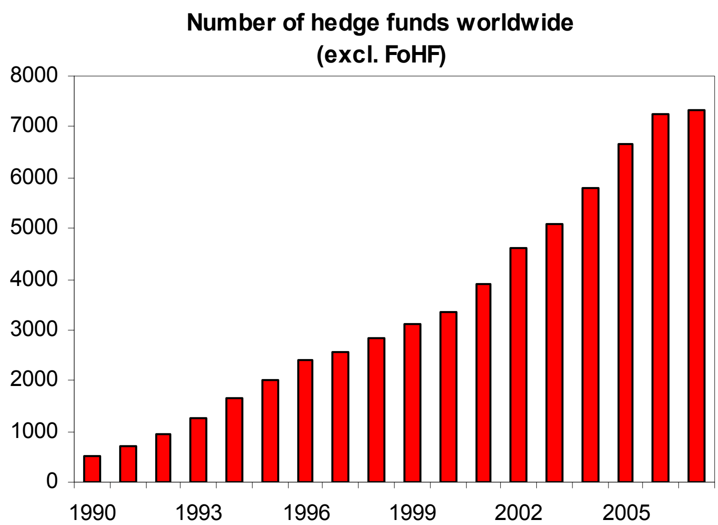
Jérôme Teïletche and Sophie Van Straelen

1 – The world hedge fund industry

The hedge fund industry has shown outstanding growth, which started to accelerate after the equity bubble burst in the early part of this decade. It is estimated that hedge funds now account for assets worth more than USD 1,500 billion, and their numbers have reached more than 8,000. These statistics are taken from the HFR database and some other observers have put the figures at USD 2,000 billion invested in more than 10,000 funds. Hedge funds still account for only a minor fraction of worldwide assets (2% to 3%), even when leverage is taken into account. Yet, they indisputably form the most dynamic segment of asset management.

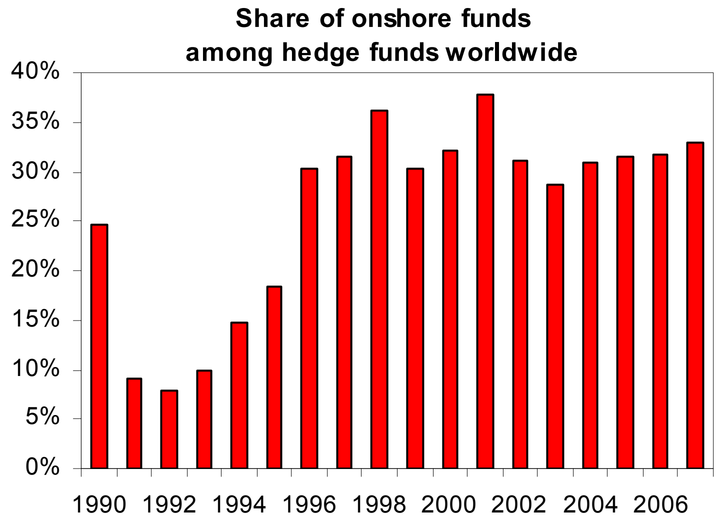


Source: HFR.



Source: HFR.

As investment vehicles, hedge funds offer several features. On the one hand, a large proportion of the funds are beyond the reach of conventional regulators, with a predominance of offshore funds (70%). On the other hand, investors frequently rely on funds of funds, which account for some 40% of the assets in hedge funds. In exchange for fixed or variable fees, funds of funds provide investors with many services: better liquidity than the underlying hedge funds, selection of managers and allocation of assets to different investment strategies, attenuation of operating risks when dealing with unregulated funds, etc.



Source: HFR.

The geographical distribution shows that hedge funds are still primarily based in the USA. The expansion of European hedge funds has been strong, with the London market driving growth, but without being the sole source of it. Asia is seeing growing interest in hedge funds, particularly long/short equity funds.

Distribution of hedge fund assets by country (mid-2006)

	USDbn
USA	870.0
United Kingdom	320.0
Europe	118
Australia	47
Asia ex-Japan	34
Switzerland	23
Canada	11
Japan	7
TOTAL	**1450**

Sources: IOSCO, OECD.

In terms of investment strategy, funds based on equities, including long/short funds and event-driven funds, dominate the industry. Global macro funds and CTA funds (trend-followers) dominated the industry in the early 1990s, but they play a smaller role today.

Distribution of hedge fund assets by strategy (1st quarter 2007)

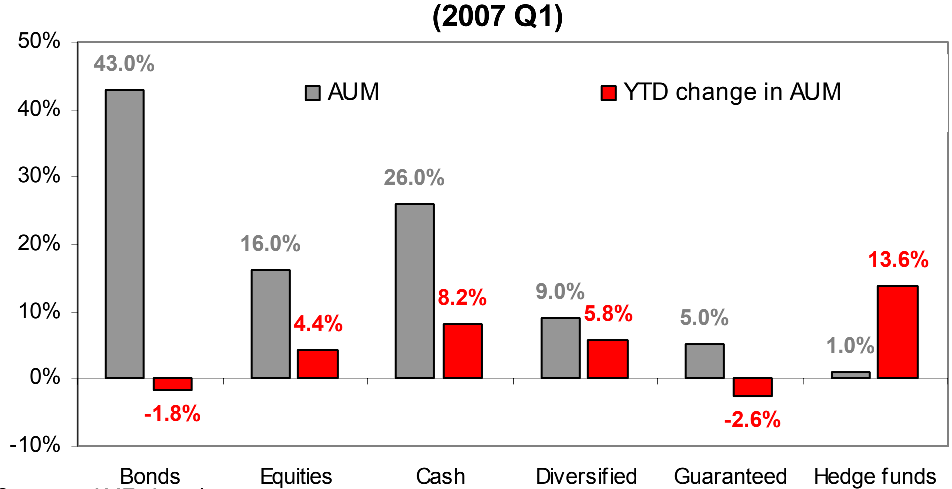
Long/Short				
	Long/Short		Others	
	Equity hedge (Long/Short)	28.2%	Macro / CTA	11.2%
	Equity non-hedge	3.9%	Fixed income high yield	1.6%
	Emerging markets	4.3%		
	Short selling	0.3%		
	Sector	5.1%		
Arbitrage				
	Special situation funds		Others	
	Event-driven	13.3%	Relative value arbitrage	13.0%
	Distressed securities	5.1%	Convertible arbitrage	3.1%
	Merger arbitrage	1.5%	Equity market neutral	2.4%

Source: HFR

2 – ARIA funds

The rules for lightly-regulated ARIA funds were introduced in 2003 to promote the emergence of onshore hedge funds in France. Statistics compiled by the AMF and restated by Asterias show that ARIA funds accounted for 1% of the assets in collective investment schemes in France in the first quarter of 2007. This is a small percentage, but it is noteworthy that such funds are now the fastest-growing family of funds.

Analysis of funds by strategy class (2007 Q1)



Sources: AMF, Asterias

More than two-thirds of ARIA funds are pure funds of hedge funds (FoHFs), meaning funds of funds investing in funds covering most investment strategies. There are also less diversified funds, where at least 40% of the assets are invested in a single strategy. These 41 sector funds include 27 (65.9%) relying on the long/short equity strategy, eight (19.5%) relying on fixed-income arbitrage), two (4.9%) that are CTA funds, while the four remaining funds rely on four other strategies (global macro, emerging markets, equity market neutral, event-driven). Around 10% of the ARIA funds are highly "diluted" with a money market component account for more than 40% of the assets.

Distribution of funds of hedge funds at the end of the 1st quarter 2007

	Number of funds	Assets in EUR billions
Multi- strategy	127 (63.8%)	16.07 (69.7%)
Sector funds (40% or more of the fund is invested in the same strategy: *equity hedge long/short, fixed income arbitrage, etc.*)	41 (20.6%)	3.72 (16.1%)
Money market (40% or more of the fund is invested in the money market)	19 (9.5%)	3.08 (13.4%)
Hybrid (a substantial share of the fund is conventionally managed	10 (5.0%)	0.93 (4.0%)
Tracker funds	2 (1.0%)	0.04 (0.2%)
Total	199 (100.0%)	23.04 (100.0%)

Sources: AMF, Asterias.
NB: There were 260 hedge funds, but Asterias avoids double counting on account of various shares.

<u>3 – What can FoHFs contribute to households' portfolios?</u>

A major issue concerns the contribution provided by hedge funds in a portfolio containing standard equities and fixed income assets. The problem is that most hedge funds are lightly regulated and do not have to provide standardised and periodic reports of their performance. Of course, the issue for ARIA funds cannot be stated in the same terms, but the lack of a track record – the rules were only introduced in April 2003 – limits the scale of reporting.

Therefore, in the early stages, we rely on an overall indicator for a picture of what FoHFs are likely to contribute to French investors. At a later stage, we will present a similar index for ARIA funds. Before then, we start with a series of important remarks and warnings about measuring hedge fund performances.

3.1. Some preliminary remarks about measuring hedge fund performance

Conventionally, the contribution that a class of assets makes to a portfolio is determined by looking at some simple statistics: (i) mean return; (ii) risk, as measured by volatility (i.e. standard deviation); (iii) the correlation of the returns on the various assets. A financial asset helps improve the performance profile of the portfolio if, for a given level of risk, it improves the mean return on the portfolio, or if, for the same mean return, it reduces the risk exposure of the portfolio. Generally speaking, such improvements can be obtained by adding assets with a high Sharpe ratio, which expresses unit risk return[82], and weak correlation with other assets.

The specific characteristics of hedge fund returns raise several problems that make it difficult to apply the conventional approach described above[83].

One of the first problems is that the hedge fund performance indicators are biased in different ways. Some of the most frequently mentioned biases in indicators for individual funds are: (i) selection bias: since the figures are based only on those funds that voluntarily report their performances, it is likely that funds have more incentive to report their performances if they are good; (ii) survivorship bias: funds that fail stop reporting and no longer affect the indicator; (iii) incubation bias: funds choose to report their performances to a database only after building up a sufficient track record, but they only do

[82] The Sharpe ratio is the most commonly used risk-adjusted performance measurement ratio. In practice, the Sharpe ratio is calculated as the ratio between the excess of the mean return on an asset over the risk-free rate and the standard deviation of returns.
[83] For recent analysis, see Fung, W., D. Hsieh, 2006, Hedge Funds: An Industry in Its Adolescence, Federal Reserve Bank of Atlanta Economic Review, 4th quarter; Lhabitant, F.-S., 2006, Hedge funds: Quantitative Insights, Wiley Finance; Lo, A., 2006, The Dynamics of the Hedge Fund Industry, CFA Digest.

so if the fund survives, which probably means that it performs well. The academic consensus is that the effects of these biases are between 2% and 4% per year. A simple way of correcting for these biases is to use funds of funds indicators, since funds of funds have to include funds that fail in their performances, while their own rate of survivorship is high. This means that their own performances are recorded in databases over long periods. The funds of funds indicator HFR FOF has underperformed the aggregated indicator for individual funds[84] by nearly 4% per year on average since 1990.

In another vein, there are problems valuing certain positions in illiquid assets. The result can be unintentional smoothing, which may have substantial consequences. Even though the smoothing may not necessarily affect the expected return, it does lead to an underestimation of the fund's volatility and its correlation with liquid assets and other illiquid assets. This problem is a familiar one for other alternative investments, such as private equity or real estate. It seems to have a significant impact on some hedge fund investment strategies, particularly in fixed income markets taken in the broadest sense, including convertible arbitrage, distressed securities, high-yield securities, mortgage-backed securities, credit derivatives, etc. At the level of the hedge fund industry as a whole, this impact is probably not as great because other hedge fund investment strategies focus on assets that are highly liquid. Such strategies are applied by global macro funds, CTA funds and long/short equities funds.

It is also generally acknowledged that conventional measurements, such as the Sharpe ratio, are not suited for many hedge fund investment strategies. More specifically, such measurement tools are based on volatility and give a very imperfect account of non-standard risks, since standard deviation does not measure extreme loss[85] risk accurately. In academic literature, many hedge fund investment strategies have been identified that show very specific distributions of returns, which combine a strong proportion of small positive returns with some very rare occurrences of very large losses. In statistical terms, such distributions are said to be skewed and have heavy tails. This means that the standard deviation, which provides a satisfactory characterisation of risk in a normally distributed universe, does not work here and it is better to use more direct measurements of extreme risk instead. Several academic studies have shown that consideration of their impact on skewness and distribution tails (extreme movements) could make adding hedge funds to a conventional portfolio a less attractive proposition[86]. In business and financial terms, such distributions of returns are rationalised by assuming that certain hedge fund strategies can be treated as options positions taken on the reference market as part of very dynamic position management policy.

Ultimately, the conclusion of this section is that hedge fund performance analysis is a delicate matter because of the biases affecting return measurements and evaluations of the actual risks incurred. Therefore, statistical studies in this area, particularly comparisons with more conventional assets, need to be interpreted with care. At the very least, prudence dictates that we focus on sufficiently diversified indicators in terms of investment strategies.

[84] It should be noted that the differential also includes the additional fees of the funds of funds.

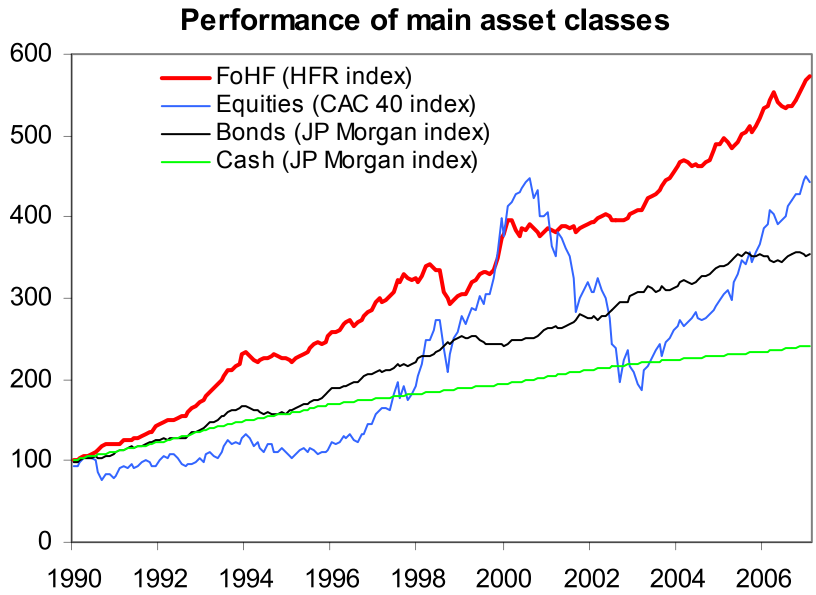
[85] It is important to point out that this extreme risk corresponds to a market risk, in contrast to the extreme risk stemming from the operational failures of funds. Failed fund risks are primarily found in the survivorship bias described above, which affects the mean.

[86] See, inter alia, Kat, H., G. Amin, 2003, Stocks, Bonds and Hedge Funds: Not a Free Lunch!, *Journal of Portfolio Management*.

3.2. What can FoHFs contribute to a diversified portfolio? The case of an overall hedge fund indicator

To give ourselves a good deal of historical distance, we start by using an overall funds of funds indicator. More specifically, we use the HFR funds of funds index, which we adjust to hedge against dollar/euro currency risk, since the index is denominated in dollars. To account for the other assets of French investors, we have chosen the CAC 40 index for equities and the JP Morgan indices for government bonds and money market instruments. All of these indices are observed at monthly intervals and they all track total returns, including coupon and dividend payments.

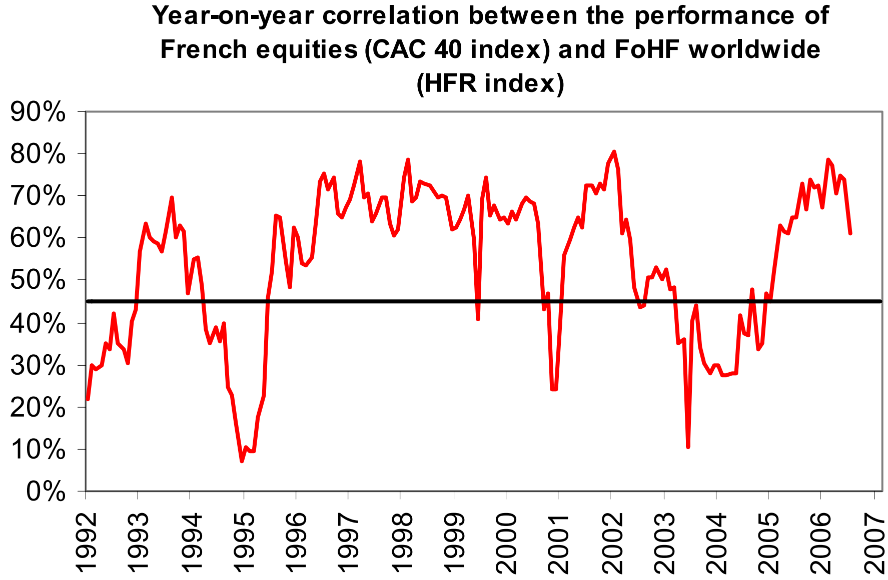
The following chart shows that, strictly in terms of returns, FoHFs seem to have outperformed the other classes of assets. Ultimately, with a mean return of slightly more than 10% (10.4%), the typical annual performance of FoHFs is equivalent to that observed for equities (10.6%), substantially better than that observed for bonds (about 7.5%) and about double the return on money market instruments (5.2%).



The chart seems also seems to show that, compared to equities, the risk associated with FoHFs looks much lower, with much less dispersion around the curve[87]. From 1990 to 2007, gross volatility of returns stood at 5.6% per year, compared to 19.3% for equities, 4.0% for bonds and 0.9% for money market instruments. The comparison of risk and return statistics made some professionals say that hedge funds offered the same return as equities, with the same risk as bonds. In this context, an investment in hedge funds would indisputably outperform the two conventional investments.

Funds of hedge funds seem to be primarily correlated to equities, with the correlation of monthly returns standing at 45%, and less strongly correlated with bonds (15%) and money market instruments (25%). The correlation with equities is moderate, but one of its key features is its high variability over time. For example, the correlation was weaker between 2000 and 2002 as equities dipped sharply. It then grew stronger after 2003, as equities recovered. This ability that hedge funds have to modulate their market exposure advantageously is called the "alternative beta".

[87] This weaker dispersion, thanks to the capitalisation effect, explains why the funds of hedge funds index shows that more wealth had been gained by the end of the period, even though the mean returns were equivalent to those on equities.



Even leaving aside the fact that the representativeness of hedge fund indices in the early 1990s is highly doubtful, the results shown above still seem debatable, given the poor capture of risk by such measurements as standard deviation in the case of illiquid assets displaying non-Gaussian distributions.

We have accounted for these elements by correcting the returns series for implicit smoothing, as can be identified through the autocorrelative structure of the data[88], and we use a measurement that focuses more on extreme risk through the CVaR[89]. After correcting for smoothing, we revised the estimated volatility of returns on hedge funds upwards from 5.6% to 8.1%, we revised the correlation between equities and hedge funds from 45% to 60% and the size of extreme losses, with CVaR at 95%, was revised from 2.8% to 4.4%.

Base on this set of statistics, we can evaluate the overall contribution of adding FoHFs to the portfolio by means of a simple exercise. We assume that an investor starts with a portfolio that is equally weighted between equities, bonds and money market instruments, which corresponds approximately to the allocation of collective investment schemes in the euro area. We add FoHFs in graduated steps from 0% to 20% of the total assets in the portfolio, which remains equally weighted between the three standard asset classes.

Adding hedge funds significantly improves the overall portfolio performance, with an increase in mean return and a simultaneous decrease in risk as a result of the diversification effect. Consequently, the risk/return profile is greatly improved, as is shown by the gradual increase in the Sharpe ratio and in the modified Sharpe ratio, in which risk is captured by the CVaR.

[88] The underlying idea is that returns are strongly autocorrelated, or, in other words, the returns for a given month are strongly influenced by returns in previous periods. This can be interpreted as evidence of strong smoothing, since, returns should not show any strong temporal autocorrelation naturally (efficient market hypothesis), or else they would give rise to arbitrage. See Getmansky, M., A. Lo, I. Makarov, 2005, An Econometric Analysis of Serial Correlation and Illiquidity in Hedge-Fund Returns, *Journal of Financial Economics*.

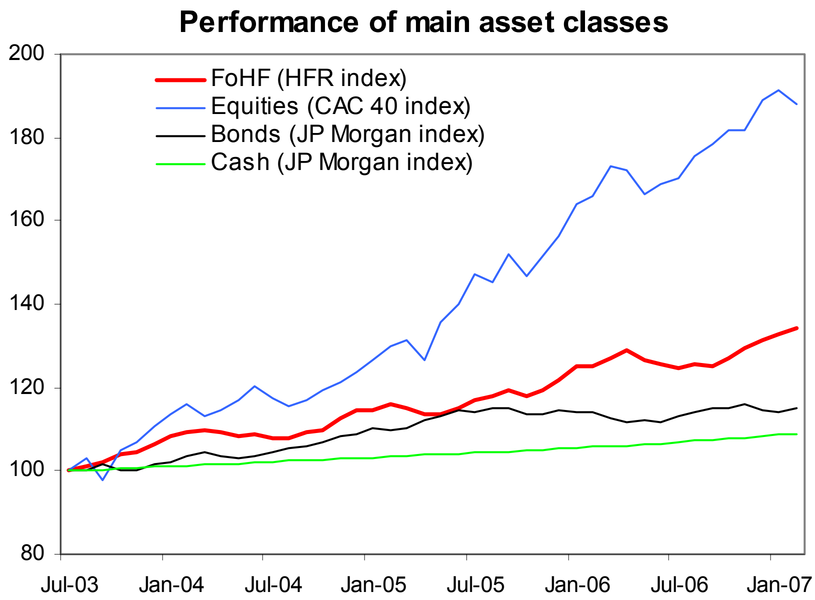
[89] CVaR (Conditional Value at Risk) corresponds approximately to the mean of extreme losses. The threshold for determining that a loss is extreme is fixed by the Value at Risk (VaR). This value is more widely known, but it has many limitations compared to the CVaR. More specifically, it does not always comply with a basic principle of finance, which is the sub-additivity of risks stemming from the diversification effect. We use an empirical CVaR at the 95% confidence level. For a very detailed presentation the relevant risk indicators for hedge fund management, see Amenc N., P. Malaise, M. Vaissié, 2005, Edhec Funds of Hedge Funds Reporting Survey: A Return-Based Approach to Funds of Hedge Funds Reporting, Edhec Risk and Asset Management Research Centre Publication.

Adding global funds of hedge funds and the risk/return profiles of portfolios

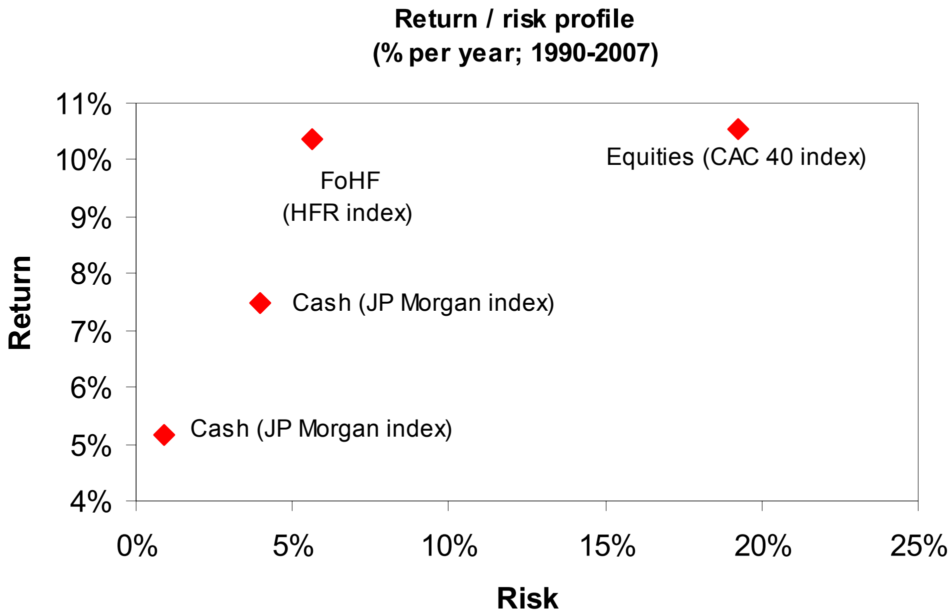
Bonds	Cash	Equities	Funds of hedge funds	Mean return	Volatility	Sharpe ratio	CVaR	Modified Sharpe ratio
33.3%	33.3%	33.3%	0.0%	7.73%	6.74%	0.38	3.79%	0.68
33.0%	33.0%	33.0%	1.0%	7.76%	6.72%	0.39	3.77%	0.69
32.7%	32.7%	32.7%	2.0%	7.79%	6.71%	0.39	3.75%	0.70
32.3%	32.3%	32.3%	3.0%	7.81%	6.69%	0.40	3.73%	0.71
32.0%	32.0%	32.0%	4.0%	7.84%	6.68%	0.40	3.72%	0.72
31.7%	31.7%	31.7%	5.0%	7.87%	6.66%	0.41	3.70%	0.73
31.3%	31.3%	31.3%	6.0%	7.89%	6.65%	0.41	3.68%	0.74
31.0%	31.0%	31.0%	7.0%	7.92%	6.63%	0.42	3.66%	0.75
30.7%	30.7%	30.7%	8.0%	7.95%	6.62%	0.42	3.65%	0.76
30.3%	30.3%	30.3%	9.0%	7.97%	6.61%	0.42	3.63%	0.77
30.0%	30.0%	30.0%	10.0%	8.00%	6.59%	0.43	3.61%	0.78
29.7%	29.7%	29.7%	11.0%	8.03%	6.58%	0.43	3.60%	0.80
29.3%	29.3%	29.3%	12.0%	8.05%	6.57%	0.44	3.58%	0.81
29.0%	29.0%	29.0%	13.0%	8.08%	6.56%	0.44	3.56%	0.82
28.7%	28.7%	28.7%	14.0%	8.11%	6.55%	0.45	3.55%	0.83
28.3%	28.3%	28.3%	15.0%	8.13%	6.54%	0.45	3.53%	0.84
28.0%	28.0%	28.0%	16.0%	8.16%	6.54%	0.46	3.51%	0.85
27.7%	27.7%	27.7%	17.0%	8.19%	6.53%	0.46	3.49%	0.86
27.3%	27.3%	27.3%	18.0%	8.21%	6.52%	0.47	3.48%	0.88
27.0%	27.0%	27.0%	19.0%	8.24%	6.52%	0.47	3.46%	0.89
26.7%	26.7%	26.7%	20.0%	8.26%	6.51%	0.48	3.45%	0.90

3.3. What can FoHFs contribute to a diversified portfolio? The more specific case of ARIA III funds

We can try a similar exercise with ARIA III funds. But, in this case, the exercise covers a shorter period of time, starting in August 2003. Some of the funds existed before that date, but we prefer to limit ourselves to the period in which the ARIA legislation has been applied. We have compiled an index of ARIA III funds. More specifically, we have selected all of the ARIA III funds with assets of more than EUR 20 million, and then calculated an equally weighted mean of their performances. The index is then chained monthly. ARIA FoHFs (ARIA III) posted steady increases over the whole period.



We use the same methodology as above[90]. In terms of risk/return profiles, FoHFs still outperform bonds sharply. The comparison with equities is more complex, since equities enjoyed a period of outstanding gains.



This means that any reduction in equities in the portfolio, however small, leads to a decrease in mean return. On the other hand, adding FoHFs led to an overall reduction in risk. Ultimately, the risk/return profile of the portfolio has been improved, as is shown by the increase in the conventional Sharpe ratio and the modified version that captures risk through CVaR. However, it is noteworthy that the modified Sharpe ratio shows a point of inflexion and the improvement in the risk/return profile is no longer seen above a certain threshold when adding FoHFs. This suggests that accounting more directly for extreme risk does not reduce the attraction of hedge funds, but it attenuates observations based on

[90] It is noteworthy that we were able to reveal a significant smoothing pattern in this case. However, this result may be attributed to the small size of the sample.

more conventional measurements, such as standard deviations. In view of the small size of the sample and its particularities, we shall refrain from drawing any overly definitive conclusions about the funds concerned.

Adding global funds of hedge funds and the risk/return profiles of portfolios

Bonds	Cash	Equities	Funds of hedge funds	Mean return	Volatility	Sharpe ratio	CVaR 95%	Modified Sharpe ratio
33.33%	33.33%	33.33%	0%	8.26%	3.54%	1.66	1.34%	4.36
33.00%	33.00%	33.00%	1%	8.24%	3.51%	1.66	1.33%	4.37
32.67%	32.67%	32.67%	2%	8.21%	3.49%	1.67	1.33%	4.38
32.33%	32.33%	32.33%	3%	8.19%	3.47%	1.67	1.32%	4.39
32.00%	32.00%	32.00%	4%	8.16%	3.44%	1.67	1.31%	4.40
31.67%	31.67%	31.67%	5%	8.14%	3.42%	1.68	1.30%	4.42
31.33%	31.33%	31.33%	6%	8.12%	3.40%	1.68	1.29%	4.43
31.00%	31.00%	31.00%	7%	8.09%	3.38%	1.69	1.28%	4.44
30.67%	30.67%	30.67%	8%	8.07%	3.35%	1.69	1.27%	4.45
30.33%	30.33%	30.33%	9%	8.05%	3.33%	1.69	1.26%	4.46
30.00%	30.00%	30.00%	10%	8.02%	3.31%	1.70	1.26%	4.48
29.67%	29.67%	29.67%	11%	8.00%	3.29%	1.70	1.25%	4.49
29.33%	29.33%	29.33%	12%	7.98%	3.27%	1.70	1.24%	4.48
29.00%	29.00%	29.00%	13%	7.95%	3.25%	1.71	1.25%	4.45
28.67%	28.67%	28.67%	14%	7.93%	3.23%	1.71	1.25%	4.41
28.33%	28.33%	28.33%	15%	7.90%	3.21%	1.71	1.26%	4.38
28.00%	28.00%	28.00%	16%	7.88%	3.19%	1.72	1.26%	4.35
27.67%	27.67%	27.67%	17%	7.86%	3.17%	1.72	1.26%	4.31
27.33%	27.33%	27.33%	18%	7.83%	3.15%	1.72	1.27%	4.28
27.00%	27.00%	27.00%	19%	7.81%	3.13%	1.73	1.27%	4.25
26.67%	26.67%	26.67%	20%	7.79%	3.11%	1.73	1.28%	4.21

Annex 7

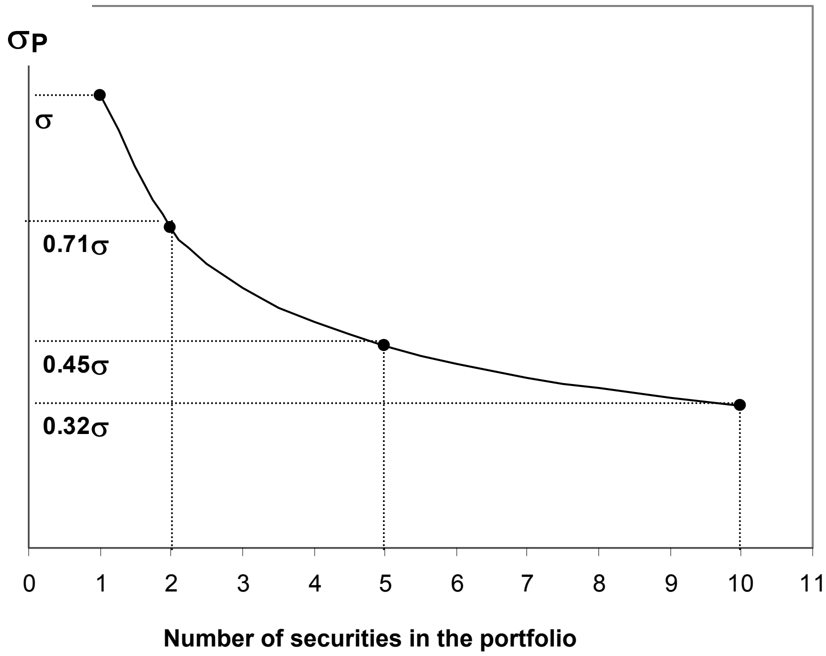
Hedge funds and portfolio diversification
Olivier Davanne and Jérôme Teïletche

1 – Basic remarks about diversification

Diversification is one of the founding principles of finance. It expresses a type "free lunch" offered to investors: diversification gives investors an opportunity to reduce the risk of their investments merely by accumulating underlying assets, without any reduction in the expected return.

In cases where the underlying assets are completely uncorrelated, diversification can even eliminate risk altogether. With ten equally-weighted securities (under the "naïve" diversification approach), risk is reduced by more than two thirds (see chart). With 100 uncorrelated equally-weighted securities, the remaining risk is only one tenth of the risk incurred in an investment in a single security.

Illustration of the diversification effect
(uncorrelated assets with the same individual risk)



But assets are never completely uncorrelated and there are some common factors and an incompressible market risk that cannot be eliminated through diversification. There is such a thing as a free lunch, but no miracles: diversification deals only with the specific risk of different securities.

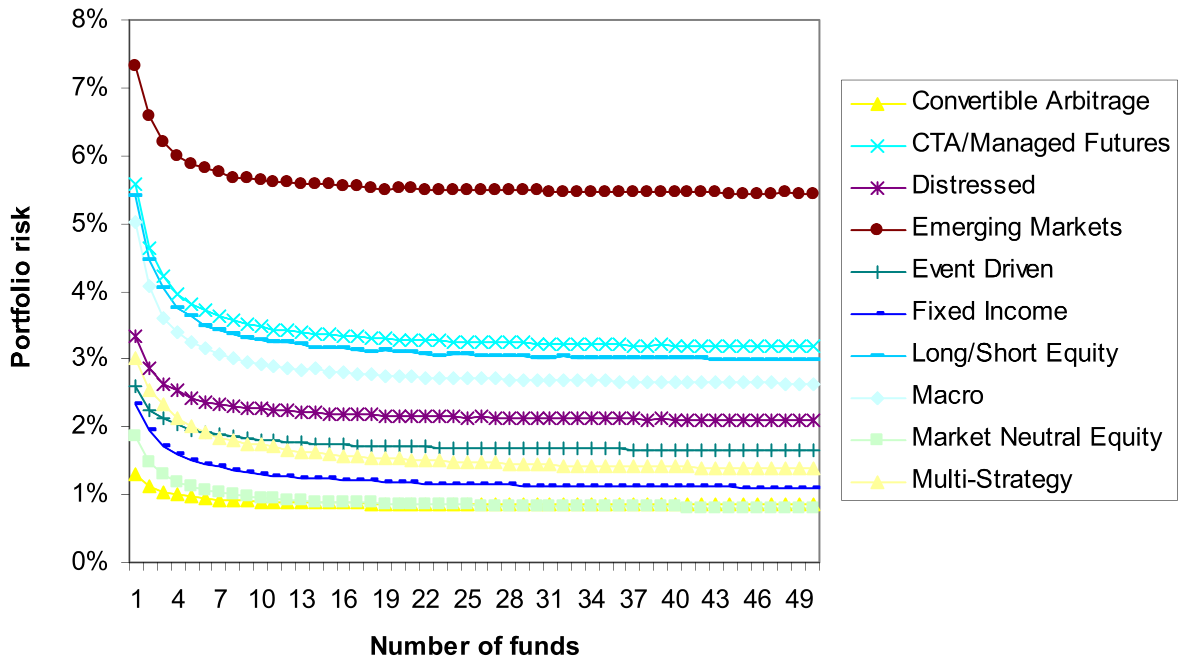
One of the key questions on the equities market since the nineteen-sixties has been how many different securities it takes to obtain the bulk (say more than three quarters) of the diversification benefits in terms of reducing security-specific risk in a portfolio. This is an empirical question and the answer hinges on the correlations between different equities. It is generally felt that it takes about twenty different securities to achieve a high degree of diversification, even though the results observed vary widely.

2 – Applications for hedge funds

Recent empirical research has focused on the benefits of "naive" diversification, which is diversification achieved by equal weighting of securities, in the specific case of hedge funds (Billingsley and Chance (1996), Henker (1998), Lhabitant and Learned (2002), Schneweiss, Kazemi and Karavas (2003).

We proceeded as follows: (i) we made a random drawing of a predefined number of funds from a panel of funds and we calculated the portfolio risk; (ii) the exercise was repeated a number of times (called simulations) and the mean risk of the simulated portfolios was reported at the end. The general conclusion is that it takes slightly fewer than ten equally-weighted funds to achieve satisfactory diversification of a portfolio of hedge funds.

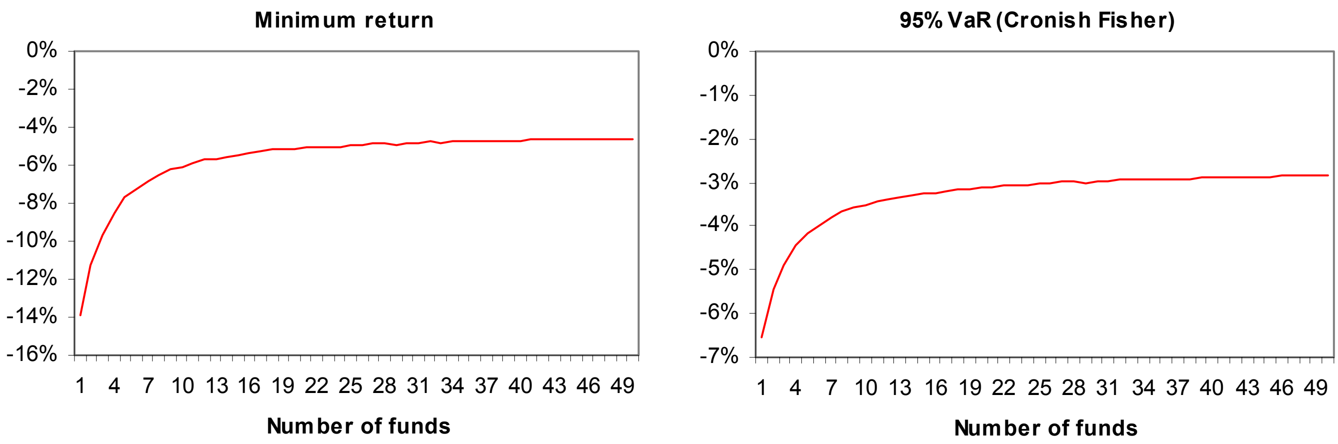
The chart below provides an illustration of this finding[91]: **if our objective is to reduce the total risk of a characteristic security by 75%, a mean of seven funds seems to be required. With ten funds, the mean reduction of total risk is 85%. These figures confirm the results obtained in the literature, but it must be understood that the reduction is a relative one, meaning a reduction of the differential between the typical risk of a fund on its own and the non-diversifiable risk on a portfolio made up of all of the funds. It is not an absolute reduction of risk.**



NB: Calculations based on the period from 1996 to 2005 for a set of 526 funds and 5,000 simulations.

It is generally acknowledged that hedge fund returns, or, in any event, returns on a large number of investment strategies, present some abnormal characteristics: the distributions are skewed and have heavy tails. Given the circumstances, standard deviation may not be the most appropriate risk measurement and it could be replaced by other Value-at-Risk measurements or minimum historical returns measuring the probability of extreme risks. Once again, it seems to take seven to ten funds to achieve a major reduction in specific risk and to bring the portfolio risk into line with that of a perfectly-diversified portfolio of hedge funds.

[91] In order to test the robustness of the results found in the literature, all of the calculations presented here were produced exclusively for this study. The calculations are based on a sample of 526 funds drawn from a combination of databases. There were nearly 5,000 funds in the preliminary drawing. We then applied various filters: (i) eliminating double counting; (ii) eliminating funds of funds; (iii) we only selected funds with a published track record of 100 months or more (some funds did not report on the most recent dates). The data were observed from 1996 to 2005.

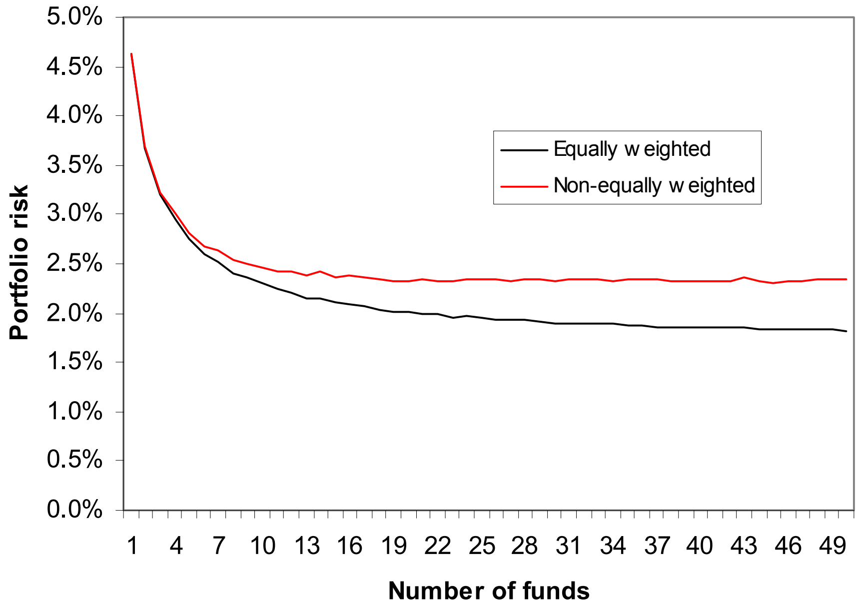


NB: Calculations based on the period from 1996 to 2005 for a set of 526 funds and 5,000 simulations.

One of the major limitations of the preceding simulations, like those cited in the academic literature, **is that they probably underestimate the risk of hedge fund failure**, especially for funds applying certain investment strategies. The underestimation is due to the survivorship bias that affects many hedge fund databases. In other words, the focus is exclusively on market risk, even though operating risk is critical in the hedge fund industry.

In the same vein, the preceding estimations assume that the funds are diversified through equally-weighted investments. Yet, this assumption is not realistic, since net asset values change and distort the relative weightings of the funds. In order to restore equal weighting, portfolios have to be reallocated frequently to reduce the allocation of the highest-performing funds and increase the allocation of funds that performed less well. This is not a realistic solution because of the lack of liquidity that characterises most hedge funds, regardless of whether investors take direct stakes or invest through the intermediary of a fund of funds.

The chart below shows that, **when funds are unequally weighted, it takes a larger number of funds to achieve the same reduction in portfolio risk.**



NB: Calculations based on the period from 1996 to 2005 for a set of 526 funds and 5,000 simulations. The unequal weighting is obtained by assuming that when funds are ranked by size, the weight of the third largest fund is 20% less than the weight of the second largest fund in the ranking. For example, with three funds, the largest accounts for 41%, the second for 33% and the third for 26%.

Another limitation of the preceding approach is that it implicitly assumes that there is a single common risk and that the other specific risks, which can be diversified through aggregation, gravitate around this risk. The unity of the common factor has already been challenged in the case of equities markets[92]. But the problem takes on an even broader dimension in the hedge fund industry, with its wide variety of investment strategies, which mean positions are taken in many asset classes (equities, bonds, currencies, commodities, real-estate, etc.) and changed very frequently, leading to non-linear exposures. Under these circumstances, diversification between investment strategies might be just as important as diversification between funds.

3 – Consequences for proper diversification of funds of funds

The preceding estimations relate to the proper diversification of the end investor's portfolio of hedge funds. Academic research indicates that diversification with only five to ten funds could be enough, but this figure needs to be revised upwards slightly to account for potentially unequal weighting of funds or shortcomings in the hedge fund databases used to carry out the simulations, which could lead to underestimation of the actual risk of hedge funds. The recent increase in correlations between investment strategies, and even between funds[93], points to a similar conclusion, even though it may merely be a cyclical phenomenon linked to the strong expansion of risk markets since the second quarter of 2003. The fact that, in practice, FoHFs are often much less concentrated than "recommended" by academic research may be related to such limitations.

In this respect, we can consider that the current 5/10/40 rule, which requires a minimum of 16 securities, is acceptable and that there is some margin for making it more flexible, but it is limited.

However, we must consider the constraints imposed on funds of funds managers as a result of such prudential rules. First of all, we can consider that, to a certain extent, a funds of funds manager's job is to make bets, on investment strategies, on a fund manager's innovative methods, etc. This gives rise to a form of concentration in the portfolio. But, more especially, a major diversification requirement could backfire by causing some smaller and medium-sized players to invest in funds without first carrying out proper due diligence and without having any leverage over the fund manager to obtain information on an ongoing basis.

If this happens, certain funds of funds could be allowed to opt out of the 5/10/40 rule and chose a cap of 15% on any single security (7 funds), as long as investors are very clearly informed of the low level of diversification. Investors could achieve diversification on their own by investing in several funds of funds, possibly with different investment strategies.

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[92] Particularly after the research by Fama, French and Carhart, which showed that beyond a certain threshold of market risk, as captured by a broad index, the valuation and risk of individual securities vary between individual securities depending on the size of the firm, depending on whether the firm is a growth business or a mature business, and depending on the past changes in prices (momentum).

[93] See, for example, Bank of Japan Review, "Changes in Hedge Fund Investment Behavior and the Impact on Financial Markets", December 2006.

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Annex 8

LIABILITY OF MANAGEMENT COMPANIES WITH REGARD TO FUNDS OF HEDGE FUNDS

Paul Zariffa

The discussions of the working group chaired by Philippe Adhémar leads us to question the extent of portfolio management companies' liability with regard to the selection of eligible investment funds as assets for FoHFs. Assuming that the current regulatory system, which is based on strict eligibility criteria fixed by the securities regulator, the Autorité des marchés financiers (AMF), evolves into an open system where choices made by portfolio management companies are covered by a due diligence process to be developed by each company, we are faced with the question of what the legal consequences would be for such companies.

This discussion is part of the broader work initiated by CESR. This work focuses on defining eligible assets for UCITS funds and is aimed at eliminating the current set lists, which are unlikely to be able to keep pace with innovations in financial products. In exchange, CESR proposes to give portfolio management companies more responsibility with respect to (i) the human and technical resources that they deploy when investing in financial products and (ii) the control systems that they implement. In this case, the planned regulations would provide guidance in the form of general principles and it would be up to portfolio management companies to transpose them into their internal structures under their own responsibility (AMF, *Revue mensuelle*, April 2007).

If we were to apply this approach to FoHFs, the range of investment funds that are eligible as investments for hedge fund UCITS would no longer be restricted by the 13 criteria set out in Article 411-34 of the AMF General Regulation. Instead, the range of eligible funds would be determined under a due-diligence process to be implemented by each portfolio management company, in accordance with the general principles set out by the AMF. In this case, management companies could modulate the diligence carried out, depending on the type of investment funds concerned and their complexity, and then explain their investment choices after the fact. In simple terms, this means that the more complex or unusual the target investment fund is, the more thoroughgoing the examination conducted as part of the due diligence process must be to enable a portfolio management company to discharge its professional obligations.

This type of approach opens up some interesting possibilities for FoHFs professionals. Several of the funds that are excluded from the investment universe of hedge fund UCITS today could become eligible if they pass the due diligence test. However, this would have an impact of the liability of the same professionals with respect to their management. Consequently, we shall outline the consequences for (I) portfolio management companies' administrative and disciplinary liability, and (II) their civil liability. For the purposes of this discussion, we propose to examine how these two types of liability are grounded in the applicable laws governing FoHFs, and to seek out elements of comparison to develop a clearer picture of the legal issues inherent in the proposed form of regulation. In our presentation, we have deliberately omitted portfolio management companies' criminal liability and the liability of natural persons working under the authority of or on behalf of portfolio management companies.

(I) Administrative and disciplinary liability of portfolio management companies

As part of its general responsibility for protecting savers under the terms of Article L. 621-1 of the French Monetary and Financial Code, the AMF is responsible for ongoing supervision of portfolio management companies under the terms of Article 621-9 of the same Code. It has the power to penalise a portfolio management company for any breach of its professional obligations under the law, regulations and professional rules approved by the AMF (Article L. 621-15 of the Monetary and Financial Code).

There is a distinction between two types of professional obligations: general rules and specific rules.

● **The general rules** require investment service providers, including portfolio management companies, to comply with the conduct of business rules aimed at ensuring investor protection and the lawfulness of their transactions.

More specifically, they are required to:

> "(1) act honestly, fairly and professionally in the clients' best interests and in a manner which promotes the integrity of the market;
> (2) Conduct their business with all due skill, care and diligence in the clients' best interests and in a manner which promotes the integrity of the market;
> (3) Have the necessary resources and procedures for carrying out their business and implement these resources and procedures with concern for efficiency; […]
> (6) Strive to avoid conflicts of interest […];
> (7) Comply with all of the regulations applicable to the conduct of their business in a manner which promotes the client's best interest and the integrity of the market (Article L. 533-4 of the French Monetary and Financial Code).

The AMF General Regulation reiterates these general principles and spells them out for portfolio management companies:
"The portfolio management company must at all times have the resources, an organisational structure and procedures for supervision and monitoring that are suitable for the activities in which it engages and that comply with ethical rules. […] (Article 322-12 of the AMF General Regulation).
-"The system for controlling transactions and internal procedures […] shall operate on a continuous and periodic basis. Continuous monitoring shall relate to compliance of the asset management company's transactions, organisational structures and internal procedures with the professional obligations defined in the laws, regulations and professional rules applicable to the conduct of its businesses, with the decisions taken by the managers […] and with the contractual commitments relating to third-party asset management activities […]" (Article 322-22-1 of the AMF General Regulation).
-"Portfolio management companies must ensure independent management and promote the exclusive interests of their clients (Article 322-31 of the AMF General Regulation).
-"The organisational structure of the portfolio management company must enable it to conduct its activities with honesty, diligence, neutrality and impartiality, for the exclusive benefit of the clients or holders, and having regard for market integrity and transparency" (Article 322-46 of the AMF General Regulation).

In addition to these general rules, portfolio management companies wishing to manage collective investment schemes as FoHFs **must comply with specific rules.**

> - To start with, they must have the AMF's prior approval for a specific FoHFs programme of operations before investing the first euro in a hedge fund (Article R. 214-37 of the French Monetary and Financial Code). The standard programme includes a description of the human and technical resources that the portfolio management company will deploy (Title 3) and the due diligence process that the portfolio management company will use (Title 4) (COB, Bulletin COB, April 2003).
>
> - Portfolio management companies then have to comply with specific rules on the structure of the collective investment schemes' assets. For this purpose, they can invest in hedge funds as

long as they meet the criteria set out in the AMF General Regulation (Articles R. 214-5 (5°) and R. 214-36 of the French Monetary and Financial Code). As indicated above, the 13 criteria are set out in Article 411-34 of the AMF General Regulation.

The AMF Enforcement Committee may impose sanctions on portfolio management companies that breach their professional obligations. The Committee may issue a warning or a reprimand, or impose a temporary or permanent prohibition on providing all or part of the services provided by the portfolio management company. The Committee may also impose a fine of up to EUR 1.5 million or ten times any profits earned. In accordance with the principle of proportionate punishment, the fine depends on the seriousness of the breaches committed and the profits that may have resulted (Article L. 621-15 of the French Monetary and Financial Code). Fines are paid to the Public Treasury.

The damages incurred by investors in the collective investment scheme or the portfolio management company's clients are not among the criteria used to determine whether a breach has been committed or to determine the penalty. Unlike civil court proceedings, the disciplinary sanctions imposed by the AMF Enforcement Committee are not aimed at providing compensation for damages. The scalability of sanctions enables the AMF to maintain discipline in asset management for third parties by playing a role that can primarily be seen as a preventive one (J. J. Essombe Moussio, 1997).

The AMF can also exercise administrative policing powers that are distinct from the sanction procedures *per se*. More specifically, it can use these powers to revoke the authorisation of a portfolio management company that no longer meets the requirements or commitments for its authorisation, or an approval issued later (Article L. 532-10 of the French Monetary and Financial Code).

Even though the requirement regarding the specific programme of operations is found in the Chapter dealing with the rules governing the asset structure of collective investment schemes, it must be seen as an adjunct to the portfolio management company's general programme of operations. Furthermore, meeting this requirement is also analogous to a commitment made by the portfolio management company as a requirement for doing business in FoHFs. In any event, the AMF could seek to exercise its administrative policing powers against any portfolio management company that fails to comply with the terms of its specific FoHFs programme of operations to revoke or suspend its authorisation.

It should be noted, however, that the breaches observed might consist of both the elimination of an authorisation requirement and a breach of professional obligations. Case law seems to show that the AMF enjoys a great deal of latitude in choosing to exercise its administrative and disciplinary powers (M. Storck, 2006).

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<u>To sum up</u>: the administrative and disciplinary liability of portfolio management companies is defined by two sets of rules. On the one hand, portfolio management companies are subject to general rules that deal primarily with the deployment of adequate organisational structures and human and technical resources for their business activities. These rules take the form of rules of conduct (duty to act honestly and diligently, competency obligation, internal control requirement, etc.) On the other hand, the portfolio management company is subject to specific strictly defined rules, such as the 13 criteria.

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We should now use sanction decisions to illustrate the potential impact of the planned regulations on the administrative and disciplinary liability of portfolio management companies.

- First of all, we did not find any disciplinary decisions or case law relating to mismanagement or failure to comply with the 13 criteria for FoHFs.

- Secondly, except in one case (Pallas Stern Gestion de Capitaux and others, Financial Management Disciplinary Council, 1997, note N. Rontchevsky), no sanction decisions or case law seem to cite the existence of a due care or performance obligation.

This is because determining a due care or performance obligation is not relevant for understanding the grounds for a disciplinary or administrative sanction. The AMF Enforcement Committee and the Conseil d'Etat "shall restrict themselves to determining whether the breaches have been committed and whether they warrant the sanctions". (GSD Gestion, Conseil d'Etat, 2005, note Decoopman; GSD Gestion and M. J. Gauthier, Sanction Decision, AMF *Revue mensuelle*, 2004). In this case, both the Conseil d'Etat and the Enforcement Committee cited breaches of rules of form: amendments to the programme of operations that were not notified to the COB, inadequate internal control, no prevention of conflicts of interest, inadequate resources for the company's business activities. As N. Decoopman noted in his commentary on the decision, "the fact that these were breaches of rules of form is corroborated by the Conseil d'Etat's indifference to whether or not the clients actually suffered any damages. The prosecution of these breaches in the absence of damages signifies that the choice made by the regulator means that investor protection is ensured proactively, by requiring compliance with rules of form" (*op. cit.*). This decision is special insofar as the breaches of rules of form dealt with stem from failure to comply with general rules of conduct.

In addition, it is noteworthy that the cut-off effects stemming from 13 criteria set out in the specific rules dealing asset structure do not always seem to be taken fully into account in sanction decisions. In some cases, the UCITS Disciplinary Council seems to penalise repeated or lasting breaches (Tuffier, G. Py, UCITS Disciplinary Council, June 93; Centrale de Crédit Municipal Griffin, UCITS Disciplinary Council, Jan. 94; Banque Arjil and Arjil Gestion, UCITS Disciplinary Council, 1995, note J. P. Bornet).

In another case, the Financial Management Disciplinary Council dismissed a complaint citing a breach of a ratio on the grounds that the breach (a holding of more than 10% of the securities of one issuer) would not have occurred if the whole capital increase had taken place in the time allotted (Stratège Finance and Ms Cazaban, Financial Management Disciplinary Council, 2003). However, in the case of Etna Finance, the Financial Management Disciplinary Council sanctioned small breaches of the 5% ratio, citing the rules of conduct for dealing with conflicts of interest (Etna Finance, Financial Management Disciplinary Council, 2002).

When dealing with breaches of the general rules, we see that the regulator may sanction portfolio management companies where human and material resources are inadequate for the planned activities. Such sanctions often come with an accessory sanction for inadequate internal control.

Another case (Ethys, Conseil d'Etat, 2004, Aguila findings) upheld the sanction of a portfolio management company for failing to comply with its programme of operations. In this case, the Conseil d'Etat upheld a decision to revoke the authorisation of a portfolio management company for failure to comply with the commitments made in its programme of operations and, more specifically, for not having adequate human and material resources for its business activities.

The Financial Management Disciplinary Council also sanctioned a portfolio management company for exposing collective investment schemes to complex derivatives called "amortising forwards", without having the necessary technical and human resources to monitor such instruments (Ecureuil Gestion, Financial Management Disciplinary Council, 2002). In a way, the portfolio management company was penalised for not having deployed adequate human and technical resources to deal with an investment in an innovative financial instrument. Since the portfolio management company's internal control system failed to spot the inadequacy of the management resources implemented by the company with regard to the collective investment schemes' investments, the company was also sanctioned on those grounds as well.

In a decision where it was alleged that a portfolio management company took leveraged positions without first establishing adequate monitoring and supervision resources, the Financial Management Disciplinary Council deemed that, first, none of the laws and regulations cited stipulate specific procedures for supervision of trading in derivatives markets and that, consequently, it was up to portfolio management companies to choose the appropriate resources for carrying out this supervision, and second, it was not proven that the handling of the positions in question using the resources deployed led to any unusually adverse risks for the investors. (Société Marseillaise de Crédit SMC Gestion, Financial Management Disciplinary Council, 98)

This decision did not result in a sanction based on the complaint made, but it still noteworthy. In it, the Financial Management Disciplinary Council, without referring to any express provisions laid down by the AMF, deemed that the inadequacy of resources may also be assessed when it is up to the company itself to determine what the appropriate resources are for responding to a technical management problem.

In the Pallas Stern case cited above, the UCITS Disciplinary Council dismissed the complaints about the organisational structure established for managing conflicts of interest. It was alleged that the portfolio management company did not sell the debt securities issued by its parent company before it filed for bankruptcy. Consequently, it was alleged that the portfolio management company placed the interests of its group before those of the investors in the collective investment schemes managed by Pallas Stern Gestion. The UCITS Disciplinary Council qualified the liability of the portfolio management company with reference to the behaviour of its peers on two occasions. The first time, the Council concluded that the portfolio management company's behaviour was not different from that of other industry professionals when the credit rating of Banque Pallas Stern was downgraded. The second time, it found that the segregation of business lines implemented within the Pallas Stern group was in keeping with market practices for entities of similar size. To our knowledge, this analysis of the situation is special insofar as it refers to notions used in civil liability and not in disciplinary and administrative liability.

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Ultimately, this presentation is far from exhaustive. It is an attempt to show how the Enforcement Committee now hands down sanctions for breaches of professional rules applying to portfolio management companies and to what extent it can rely, with the appropriate changes, on the same case law if the proposed regulations are adopted.

We should also point out a major limitation of the methodology used. It does not deal with contextual circumstances that could cause the Enforcement Committee to exercise its discretion with regard to sanctions, both when handing down its sanctions (proportionate punishment principle) and in determining whether breaches of professional obligations have taken place. Such discretion is inherent in any administrative or disciplinary sanction.

II Contractual liability of portfolio management companies

The civil liability of portfolio management companies is a contractual liability (see in particular GPK Finance *et al.* vs. Guyomarch *et al*., 2002, findings Lafortune). If a collective investment scheme is unincorporated, the management company or the depositary are jointly or severally liable, as the case may be, towards third parties and investors in the scheme for violations of statutory and regulatory provisions applicable to unincorporated collective investment schemes and for violations of the scheme's rules or for negligence (Article L. 214-28 of the French Monetary and Financial Code)[94]. The contract is created when units or shares are subscribed (S. Bonfils, *op. cit*).

As a general rule, an investor who complains of irregularities in the management of a collective investment scheme does not initiate civil court proceedings against the portfolio management company. Instead, the investor sues the distributor of the collective investment scheme and the

[94] The doctrine also considers that the liability of portfolio management companies with regard to managing open-ended investment companies (SICAV) is also contractual in nature. Even though the Financial Markets Committee has said nothing on this topic, the rules are the same as those applying to joint-stock companies. Shareholders are linked to the company under the terms of a shareholder agreement. The liability rules for unincorporated investment funds apply, with the necessary changes, to open-ended investment companies. (See Bonfils, S., 2004)

distributor will then sue the portfolio management company. This presentation does not deal with the liability chain, but it should be studied since the contractual relationships seem to be skewed between the contract linking the investor and the distributor and the contract linking the distributor and the portfolio management company. The subject will come up again with the transposition of the Markets in Financial Instruments Directive into French law.

Case law and doctrine concur that the liability of portfolio management companies is mixed (S. Bonfils, *op. cit*). As a general rule they are under a due-care obligation with regard to their management and a performance obligation for certain services.

A portfolio management company cannot be bound by a performance obligation to provide capital gains for traders because stock markets are random by nature (Leborgne A, 1995). When a portfolio management company makes a management decision, it is impossible to determine whether this decision is the optimum decision, meaning that it will achieve the management objective, unless there is a contrary agreement between the parties, such as in the case of a structured fund or a fund with a capital guarantee. A management decision inherently gives the manager a degree of discretion.

Ordinary law measures the diligence and honesty of anyone who administers others' goods (management is treated as an act of administration). The administrator of the goods is judged according to a "*bonus pater familias*" test, meaning a normally prudent and diligent person. Yet, when dealing with financial management this criterion involves a higher standard. Portfolio management companies are subject to professional rules that are more demanding than those applying to an administrator under ordinary law. This means that they are not judged in comparison to a "normally diligent and prudent person", but in comparison to how a good manager would act in the same circumstances of place and time. Some observers refer to a "*bonus argentarius*" (S. Bonfils, *op. cit*.), others to a "qualified professional" (J. J. Essombe Moussio, *op. cit.*) and still others speak of an "enhanced due-care obligation" (A. Leborgne *op. cit*.).

In certain cases, portfolio management companies have been subjected to performance obligations. In most cases these are obligations proscribing certain actions or the requiring the performance of certain technical operations. This is the case where the manager has no discretion with regard to management decisions (see Cass Civ, 1977). The famous Fonds Turbo case (Cass com, 2002, findings Lafortune) is a good illustration of the case law. Unincorporated collective investment schemes paying dividends offered the possibility of receiving a tax credit certificate stemming from the subscription of funds, even though the investments were only held for a few days at the most. The certificates were issued in accordance with an Instruction from the General Tax Directorate. Yet, the tax administration did not recognise the validity of such tax credit certificates and imposed massive tax adjustments on investors in the funds. The Conseil d'Etat upheld the validity of the tax adjustment on the grounds of the unlawful operation of the funds. The investors in the schemes initiated civil liability proceedings against the portfolio management companies and the banks acting as depositaries. The Court of Cassation ruled in favour of the investors and deemed that the managers and depositaries were "bound by a performance obligation to issue a tax credit certificate that was valid for its purpose and were solely responsible for the operating choices and procedures of the funds" (F. Bussière, 2002).

To our knowledge, the courts have yet to rule on the nature of the obligation imposed on portfolio management companies when they apply the 13 criteria laid down in Article 411-34 of the AMF General Regulation. We could assume intuitively that compliance with these rules is a performance obligation, since it stipulates compliance with constraints regarding the structure of collective investment scheme assets. Yet, case law has recently weakened this assertion. In a case, the COB decided to revoke an unincorporated collective investment scheme’s authorisation and shut down the scheme on the grounds that the net asset values were overstated and that the scheme had exceeded the maximum holding ratios for an unlisted company (Prenat *et al*. vs. Société Financière Lamartine, 1999). Despite the COB’s decision, the court found that the exceeding of the ratio was involuntary and that the portfolio management company had not breached its due-care obligation. Consequently, it would be risky to assert *ipso facto* that compliance with the 13 criteria is a performance obligation.

If the proposed regulation is adopted, it will no doubt be treated as a due-care obligation. This means that the modulation of the due diligence processes carried out by portfolio management companies and, more generally, the decision to invest or sell hedge funds, will remain subject to the "qualified professional" standard of reasonableness and normality.

It should also be remembered that, in civil liability cases, proving negligence on the part of the portfolio management company does not automatically entitle the plaintiffs to compensation for damages. They must also prove the damages incurred and the chain of causation between the negligence and the damages. Then the compensation must be reconciled with any clauses limiting liability (see I. Riasetto, 2007).

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