

**The French legal and regulatory framework
Relating to (Funds of) Hedge Funds
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第二届中法金融论坛 2nd SINO-FRENCH FINANCIAL FORUM

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The French legal and regulatory framework relating to (Funds of) Hedge Funds

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Glossary

- **AMC:** Asset management company
- **AMF:** Autorité des marchés financiers
- **ARIA CIS or funds:** a specific category of CIS provided under French regulation which may apply streamlined investment rules
- **CIS:** Collective Investment Schemes (the terms « CIS » and « funds » will be used indistinctly in this presentation)
- **FI:** Financial Instrument
- **IOSCO :** International Organization of Securities Commissions
- **PO:** Programme of Operations
- **SC5 :** IOSCO Standing Committee 5 on Investment Management chaired by Hubert Reynier, AMF

Introduction

- **The Hedge Fund industry worldwide**

- ▶ 2007: significant increase of global assets under management => \$ 1,868 billion
(Hedge Fund Research)
- ▶ Funds of Hedge Funds (FOHFs): the primary vehicles used for attracting retail investment in the Hedge Fund area

- **The Hedge Fund industry in France**

- ▶ **Successful development of the industry notably as regards FOHFs**
 - ⇒ as from 31 December 2006: 239 authorized French FOHFs with assets under management of € 23 billion
 - ⇒ as from 31 December 2007: 351 authorized French FOHFs with assets under management amounting to € 37.8 billion
- ▶ **The French legal framework**
 - ⇒ allows CIS organized under French law to use alternative investment techniques and/or invest in Hedge Funds subject to specific conditions
 - ⇒ since 2003, a specific framework for FOHFs allowing any investors (e.g., retail) to have access to Hedge Fund techniques within a secure environment

Introduction

- **The Hedge Fund industry in France (continued)**

- ▶ **The recent review of the French legal framework (March 2008)**

- **Purpose of the review:** to further meet industrial developments in the area while maintaining the level of investors' protection

- **Main steps:**

- **April 2007:** the AMF launched a working group with industry representatives, lawyers, auditors, economists and professional associations to reassess the existing framework

- **July 2007:** the working group issued a report proposing recommendations for a more principles-based approach

- **October- November 2007:** consultation of the industry

- **March 2008:** the AMF amended/supplemented its 2003 FOHF regulation in light of the working group's recommendations, international works (within the IOSCO, CESR) and events (e.g., Amaranth Hedge Fund)

Introduction

The Hedge Fund industry in France (continued)

- **Outcome of the review => development of a prescriptive framework founded on the due diligence** to be carried out by AMC

and under which:

the **responsibilities of AMC** are more clearly defined for performing **appropriate due diligence**

- AMC due diligence is in particular **focused on the selection, the monitoring and the oversight of the underlying FI** contemplated for investment and invested in
- also a few **technical adjustments** are made to the rules such as authorizing French FOHFs to invest in Hedge Fund derivatives subject to specific conditions (notably regarding the AMC capacity to perform appropriate valuation and precise analysis of related risks)

I. Main principles governing the French legal framework

General principles:

- Any CIS organized under French law may use alternative investment techniques and/or invest in Hedge Funds subject to **specific conditions regarding the CIS and its AMC**
- A CIS has to be specifically registered with the AMF as a **FOHF** (*OPCVM de fonds alternatifs*) if **more than 10%** of its portfolio is exposed to units or shares of foreign investment funds and/or of French CIS following alternative investment strategies (such as ARIA CIS, contractual funds or FCIMTs (managed futures funds))

I.1 Main conditions pertaining to the CIS

► with regard to the CIS form: 4 main categories of French (Funds of) Hedge Funds:

- (i) **Contractual fund:**
 - Declaration comprising the required regulatory information to the AMF
 - Investment threshold of **€ 250,000** for non qualified investors
 - No limits relating to the types of instruments exposed to and no risk spreading rules
 - Quarterly (or more frequent) net asset value calculations
 - Definition of the investment and debt policies (including leverage) in the fund's constitutive documents

I. Main principles governing the French legal framework

I.1 Main conditions pertaining to the CIS (continued)

(ii) « ARIA I » (unleveraged CIS):

- AMF's approval required
- Investment threshold of **€ 125,000** for non qualified investors
- Exempted from certain risk diversification rules applicable to common CIS (e.g., may invest up to 35% of its assets in shares of the same issuer, 50% of its assets in another CIS)
- Monthly (or more frequent) net asset value calculations
- Leverage of only 2 (i.e., 100% of the fund's assets)

(iii) « ARIA II » (leveraged CIS):

- AMF's approval required
- Investment threshold of **€ 125,000** for non qualified investors
- Monthly (or more frequent) net asset value calculations
- Exempted from certain risk diversification rules applicable to common CIS (e.g., may invest up to 35% of its assets in shares of the same issuer, 50% of its assets in another CIS)
- Maximum leverage of 4 (i.e., 300% of the fund's assets)

I. Main principles governing the French legal framework

I.1 Main conditions pertaining to the CIS (continued)

(iv) «ARIA III» (the typical French FOHF):

- AMF's approval required
- **Investment threshold of €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 common CIS => must invest in **at least 9 underlying Hedge Funds**
- Maximum leverage of 2 (*i.e.*, 100% of the fund's assets)
- Any fees rebates between the ARIA III (top-level fund) and the underlying Hedge Funds have to be retained by the top-level fund

⇒ ARIA III funds proved to be the preferred vehicle in France for investments in Hedge Fund techniques

I. Main principles governing the French legal framework

I.1 Main conditions pertaining to the CIS (continued)

► with regard to disclosures to investors: in particular, French regulation requires that the CIS prospectus notably specifies:

- a **warning** to draw investors' attention to the fact that the fund may be riskier than a common fund as it may apply streamlined investment rules
- the **category of investors** who may subscribe
- the **investment objective and strategy** including a description of the FI intended to be invested in or exposed to
- a **description of the risks** in particular in relation to the investment objective and application of streamlined investment rules (leverage)
- the **subscription / redemption conditions** (e.g., for ARIA CIS, the period between the date of the cut-off time for subscription/redemption orders and the delivery of units or payment of redemption proceeds may be up to 60 days if the net asset value is not calculated on a daily basis)
- the frequency and conditions of the CIS portfolio **valuation**
- a description of the **fees** (subscription/redemption, management fees)
- if a FOHFs' investment strategies are not sufficiently diversified, this must be clearly specified in the prospectus
- if an ARIA CIS is only distributed outside France, name of the concerned country

I. Main principles governing the French legal framework

I.1 Main conditions pertaining to the CIS (continued)

► with regard to the CIS characteristics (eligibility criteria):

- A French (Fund of) Hedge Funds may only invest in the FI authorised under applicable law in relation to the CIS category (e.g., bonds, equity, CIS, Hedge Funds)
- **Example: an ARIA III CIS may invest in a foreign Hedge Fund provided the Hedge Fund meets 4 regulatory eligibility criteria:**
 - (i) The Hedge Fund's unitholders/shareholders shall have **real rights** to their assets;
 - (ii) The **custody** of the Hedge Fund's assets shall be provided separately of the custodian's own assets;
 - (iii) The Hedge Fund shall disseminate **adequate periodic information**, its units/shares shall be **valued appropriately** at least once a month, it shall be legally required to have **financial statements audited** at least once a year by auditors;
 - (iv) It shall not be domiciled in countries/territories identified as uncooperative by the FATF

=> the 4 criteria are based on the key aspects of the Hedge Fund's legal regime, functioning and organisation

I. Main principles governing the French legal framework

I.2 Main conditions pertaining to the AMC

► Obligation to file the relevant regulatory PO with the AMF prior to managing any (Funds of) Hedge Funds organized under French law

(under French regulation, there are several specific POs respectively for ARIA III funds, ARIA I and II funds, for contractual funds)

The PO as approved by the AMF must in particular describe in detail:

- the purpose and scope of the AMC business activities (investment objective, investment processes, characteristics of the FI to be invested in or exposed to)
- the conditions under which the AMC undertakes to conduct its activities
- the AMC due diligence policies and procedures notably in the selection, monitoring and oversight of FI contemplated for investment or invested in (e.g., Hedge Funds in the case of FOHFs)
- the controls and notably the risk management policies and procedures (nature + frequency + documentation)
- the policies and procedures regarding conflicts of interest
- the conditions for valuating the CIS portfolio
- the resources and organization of the AMC (e.g., human and technical means)

=> The PO constitutes a **legal commitment on the part of the AMC to investors and the AMF**, and a useful tool for the purpose of the AMF's ex post controls

I. Main principles governing the French legal framework

I.2 Main conditions pertaining to the AMC (continued)

► **Obligation to perform appropriate and adequate due diligence prior to and during any Investment in compliance with the PO**

- 1) **the due diligence rationale: to ensure that the AMC makes an informed investment on behalf of the CIS in the investors' best interests and has the relevant resources and organisation to proceed to and monitor the investment made**

To that end, the AMC has to proceed before and during any investment to:

- a thorough investigation and in-depth analysis of the **fundamental characteristics** of the FI contemplated for investment or invested in (e.g., risk profile, liquidity terms and its consistency with the CIS liquidity)

- an **assessment of the consistency of the investment with the CIS characteristics**, and of the risks related to the investment (e.g., fraud, operational, liquidity and legal risks)

For the purpose of its due diligence, the AMC may refer to existing codes of conduct issued by established trade associations

⇒ The French regulatory framework focuses on the due diligence pertaining to the selection, monitoring, and oversight of the FI invested in or exposed to

I. Main principles governing the French legal framework

I.2 Principal conditions pertaining to the AMC (continued)

2) the purpose of the AMC due diligence: 4 main components regarding the investment, the AMC resources and organization, the controls on due diligence, and the identification and management of conflicts of interests

=> **Appropriate due diligence on the investment itself:**

- a verification that the FI is an **eligible asset** as per applicable law, and the prospectus
- a verification that the **investment is consistent with the CIS characteristics** (e.g., its investment objectives and strategy, liquidity profile, global risk profile, targeted end investors)
- a verification that the investment is **consistent with the AMC investment decision process**
- an **analysis of the impact** of the investment onto the **CIS global risk profile** and liquidity (under normal and adverse market conditions (e.g., stress tests))

I. Main principles governing the French legal framework

I.2 Principal conditions pertaining to the AMC (continued)

⇒ Appropriate due diligence on the investment itself: (continued)

- the prior determination of the **adequacy of the CIS valuation procedures and policies** with the characteristics of the FI contemplated for investment or invested in (as the CIS is expressly required to be able at all times to value in a precise and independent manner its portfolio, and to be able to make its own valuation in the absence of available information)
- in case of delegation, the setting up of the appropriate procedures and processes for monitoring the delegatee's activities and assessing its performance
- the **monitoring of the AMC's compliance** and that of the relevant persons with the procedures, policies, processes adopted by the AMC in relation to due diligence (e.g., risk management procedures)

I. Main principles governing the French legal framework

I.2 Principal conditions pertaining to the AMC (continued)

- ⇒ **Appropriate due diligence on the AMC resources and organisation in particular, for the purpose of:**
- **Correctly valuating** the FI in a precise and independent manner
 - Measuring and analysing the FI **related risks** and their contribution to the CIS global risk profile (e.g., liquidity and capacity to meet redemption requests)
 - Appreciating the legal characteristics of the FI
 - **Evaluating the adequacy** and effectiveness of the AMC means and resources as regards the performance of its management activities and its related due diligence

I. Main principles governing the French legal framework

I.2 Principal conditions pertaining to the AMC (continued)

⇒ **Appropriate controls relating to the AMC performance of due diligence:**

- include risk management, compliance and internal controls
- require the establishment of **relevant risk management policies, procedures** and adapted mechanisms to identify and manage the risks related to the AMC activities
- are to be conducted in an **independent manner**, and on an **on-going** but also periodical basis
- have to be **adapted to the nature, scale, complexity and range of the AMC services and activities** (e.g., level of risk tolerance determined in the risk management policy)
- their adequacy and **effectiveness** over-time (notably risk management policies, procedures and mechanisms) have to be **regularly assessed** and any deficiencies addressed
- where appropriate and proportionate in consideration of the nature, complexity, scale and range of the AMC activities, require the setting up of **a risk management function** that operates independently from the AMC other functions and activities

I. Main principles governing the French legal framework

I.2 Principal conditions pertaining to the AMC (continued)

⇒ **Appropriate policies and procedures for the purpose of identifying and remedying conflicts of interest:**

- Purpose:

(i) to **identify** the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of one or more clients

(ii) determining the measures to adopt to **manage** the identified conflicts

- Need to be appropriate according to the AMC size and organisation, to the nature, importance and complexity of the AMC business activities

I. Main principles governing the French legal framework

I.2 Principal conditions pertaining to the AMC (continued)

3) Obligation to establish and maintain due diligence procedures that must:

- be **documented and traceable**
- be expressly and clearly described in the AMC PO as approved by the AMF
- be based on a qualitative and quantitative **analysis** of the FI characteristics and the **associated risks** (determination of level of risk tolerance where appropriate)
- be implemented using **suitable human and technical resources**
- **provide for the resources, procedures and organisation needed** to perform the AMC activities (e.g., via a collective investment decision making process provided the size of the AMC warrants it), to deal with any anomalies identified when monitoring the selected instruments, and to take the necessary corrective action, and keep the related records

=> Every AMC is therefore expected to be in a position to justify its investment decisions on an ex post basis

I. Main principles governing the French legal framework

I.3 External controls upon AMC activities

▶ AMF's on-going supervision and monitoring

- **Ex ante controls:** at the time of the creation and/or authorization of the AMC, and of any (Fund of) Hedge Funds to be managed by the AMC, upon any update of the PO requested by the AMC
- **Ex post controls:** at any time notably on the basis of the AMC PO, the AMC annual compliance, and risk control reports submitted to the AMF, and the CIS prospectus (in particular, as regards its consistency with the AMC PO)
 - Controls are conducted either **on site** (within the AMC premises) or **off site** (on the basis of the documents provided to the AMF)

▶ **Controls conducted by the CIS depositary** (in particular regarding the decisions taken by the AMC in the course of the CIS management)

▶ **Controls by the CIS external auditors**

II. IOSCO work on (Funds of) Hedge Funds

II.1 IOSCO recent work within the SC5 (chaired by the AMF)

► **IOSCO** « *Principles for the Valuation of Hedge Fund Portfolios* » (November 2007) :

- main purpose: to strengthen the Hedge Fund valuation process with a view to mitigating conflicts of interest
- provide for **9 high level principles** aimed at ensuring that FI held by Hedge Funds are appropriately valued (and in particular that values are not distorted to the detriment of investors)
- key foundations of the principles:
 - the elaboration and implementation of **comprehensive and written valuation policies and procedures**
 - the **periodical review** of the policies and procedures to ensure their continued appropriateness
 - the independence of the valuation process and of its monitoring

=> a useful tool for Hedge Funds' managers, governing bodies and also for investors (notably institutional and sophisticated investors)

II. IOSCO work on (Funds of) Hedge Funds

II.1 IOSCO recent work within the SC5 (chaired by the AMF) (continued)

► **IOSCO « Report on Funds of Hedge Funds »** (June 2008) :

- aims at **completing the principles** provided for in the **IOSCO February 2003 report** “Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds”
- presentation of the **key aspects of the FOHF regulation** (definition, regulation, information and transparency, investment managers’ regulation, distribution) and of the outcome of the **exchanges with the industry** (further to a consultation and 3 hearings with FOHF experts worldwide)
- **proposals to carry out further work in the 2 main areas** where additional investor protection regulatory issues have been identified:
 - (i) management of the liquidity risk
 - (ii) nature and conditions of due diligence processes used by FOHF managers

II. IOSCO work on (Funds of) Hedge Funds

II.2 IOSCO current work within the SC5 (chaired by the AMF)

► IOSCO « *Proposed Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices* »

Provide for proposals regarding FOHF managers' due diligence which:

- have been put out to **public consultation** (from 6 October 2008 until 5 January 2009)
- relate to the **2 areas** identified in the IOSCO June 2008 report on FOHFs
 - 1) **Liquidity risk: key points to be considered by FOHF managers:**
 - consistency of FOHFs' and underlying Hedge Funds' liquidity (notably in order to meet redemptions)
 - liquidity of types of FI held by underlying Hedge Funds
 - consistency of any limited redemption arrangements with FOHFs' aims and objectives
 - potential conflicts of interest between underlying Hedge Funds and other relevant parties

II. IOSCO work on (Funds of) Hedge Funds

► IOSCO « *Proposed Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices* » (continued)

2) Nature and conditions of FOHF managers' due diligence prior to and during any investment:

- Importance of establishing and maintaining appropriate due diligence **procedures to be reviewed periodically**
- **Elements to be constantly monitored and analyzed:** in particular, legal and regulatory requirements applicable in the underlying Hedge Fund's jurisdiction regarding notably disclosure, custody, periodical valuation, compliance with IOSCO 2007 valuation principles, adequacy of risk management approach, adequacy of underlying Hedge Fund's investment strategy, adequacy of systems to manage conflicts of interest, controls)
- **Relevant resources, procedures and organisational structures** (e.g., documented and traceable procedures for Hedge Funds' selection, adequate human and technical resources to implement due diligence procedures, capability to deal with anomalies)
- In case of outsourcing, management of conflicts of interest

=> Consistency of the proposed principles with the French legal framework

Conclusion

The French legal framework on (Funds of) Hedge Funds

▶ A detailed approach

- focused on the **AMC due diligence** regarding the selection, monitoring and oversight of the underlying FI
 - relying on a **clear legal commitment on the part of AMC** (on the basis of their PO approved by the AMF)
 - subject to **on-going and periodical controls** (by the AMF, the CIS depositaries, external auditors)
- ▶ An access of retail investors to Hedge Fund techniques within an adapted and controlled environment
- ▶ Consistency with the current international works and initiatives (e.g., IOSCO valuation principles for Hedge Funds and proposals on FOHF, CCSR's guidelines on eligibility of Hedge Fund indices to UCITS subject to specific conditions, UK FSA work on Funds of Alternative Investment Funds)
- ▶ **Regularly assessed** and reviewed to make sure the French framework is up to date without compromising investor protection

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