

ESMA's draft technical advice to the European Commission on possible implementing measures of the AIFM Directive

Responses from HDF Finance

September 13th, 2011

INTRODUCTION: HDF Finance in summary

- HDF is an independent French asset management firm created in 1986 and based in Paris, with a presence in Switzerland and New York.
- HDF, as of end December 2010, manages about \$ 2 billion in total assets, through a range of French regulated funds (85% of total AUM) and a range of funds based in Luxembourg (15% of total AUM).
- Ever since its creation, HDF specialized exclusively in the management of funds of funds. Today, funds of alternative funds represent 90+% of our total assets under management. We do not manage any single manager fund.
- The performance of our funds of alternative funds has been consistently robust over the past twenty years, with returns equal to or above market returns at a much lower level of risk. In 2001 and 2002, for instance, our funds of alternative funds have generated positive annual returns at a time when equity markets were down by 30%, 40% or more. In 2008, our funds have delivered performances ranging from positive to about a third of the decline in equity markets, and much better than most hedge funds indices.
- HDF, through a conservative and in depth due diligence process, focused on financial and operational risks, has consistently avoided the major problems that plagued the hedge funds industry, such as Madoff, Amaranth, Bayou, Manhattan or LTCM.

As a result, it must be clear that comments submitted below relate mostly to hedge funds or funds of hedge funds.

Article 3 Exemptions

Question # 7: Do you consider that valid foreign exchange and interest rate hedging positions should be excluded when taking into account leverage for the purposes of calculating the total value of assets under management?

Foreign exchange and interest rate hedging contracts are aimed at reducing not increasing the exposure to certain risk factors. Such positions, therefore, should be excluded from the calculation of the total value of assets under management as these positions are established for hedging purposes and are designed to provide a protection against adverse movements in rates of exchange or of interest. They are not positions in the general sense; if included in the calculation this would amount to an unjustified form of double counting.

Question # 9: The risk to be covered according to paragraph 2 (b)(iv) of box 6 (the improper valuation) would also include valuation performed by an appointed external valuer. Do you consider this as feasible and practicable?

No. When valuation is conducted by an external valuer, appointed upon appropriate due diligence, this type of risk should be dealt with/addressed by such valuer.

General Principles

Question # 16: Paragraphs 4 and 5 of Box 11 set out additional due diligence requirements with which AIFMs must comply when investing on behalf of AIFs in specific types of asset e.g. real estate or partnership interests. In this context, paragraph 4(a) requires AIFMs to set out a "business plan". Do you agree with the term "business plan" or should another term be used?

"Operations program" is preferable to "business plan" which has more a commercial or marketing connotation.

Risk management

Question # 18: ESMA has provided advice as to the safeguards that it considers AIFM may apply so as to achieve the objective of an independent risk management function. What additional safeguards should AIFM employ and will there be any specific difficulties applying the safeguards for specific types of AIFM?

The discussion of risk management and of safeguards regarding risk management would be better treated if a clear distinction had been made in the directive and in the consultation paper between (i) "risk management" and (ii) "risk control". Risk management is, inherently, a key and essential responsibility of the portfolio management function; a portfolio manager must manage all risks related to the portfolio under his/her responsibility. On the other hand, "risk control" must be exercised on the basis of functional and hierarchical separation from the investment management line, which is what the directive deals with, in fact. It is unfortunate this distinction has not been made in the directive and

in the consultation paper; the use of the expression “risk management” in lieu of “risk control” is a source of unnecessary complication.

This said, safeguards to ensure the functional and hierarchical separation of “risk control” from the investment or portfolio management line should mostly involve:

- in general, clear reporting lines of the risk control function to the chief executive officer of the firm,
- a formally documented policy in terms of information provided to the governing body of the fund: either, the board of directors of the fund whenever the fund is a distinct incorporated legal person and the firm’s own board of directors in the case of unincorporated investment funds, such as French “Fonds Communs de Placement”.

Question # 19: ESMA would like to know which types of AIFM will have most difficulty in demonstrating that they have an independent risk management function? Specifically what additional proportionality criteria should be included when competent authorities are making their assessment of functional and hierarchical independence in accordance with the proposed advice and in consideration of the safeguards listed?

Private equity and real estate funds will have the most difficulty in demonstrating they have an independent risk management function as (i) risk management is part of the on going management of these funds and (ii) as risk management and risk control are difficult to segregate as distinct functions in the case of these two types of funds; nevertheless, risk control can be enforced through periodic assessments of the investments of these funds, as for other types of AIF. In the case of hedge fund type AIFs, the distinction between risk management and risk control is much less problematic and easier to implement.

In all cases where an independent risk committee cannot be considered by virtue of the size of the AIFM, the most basic safeguards are: (i) to require a formal documentation of the risk management policies and procedures implemented by the AIFM and (ii) to require the portfolio management function to report to the fund governing body on a regular basis (say, quarterly) on : (i) compliance with the risk policy of the AIF, (ii) the risk profile of the AIF and changes thereof, (iii) compliance with risk management procedures and (iv) any implemented or required remedial actions.

Note: Care should be taken about point 3. (b) of article 15 which refers to the measurement, management and monitoring on an on-going basis of risks associated with “*each* investment position” of the AIF. In the case of many hedge fund strategies involving large numbers of positions and high turnover, such on-going requirement is not practical, feasible and, more importantly, meaningful. It is therefore appropriate, as the consultation indicates in box 25, to refer to “risks relevant to each AIF’s investment strategy” rather than “investment position”.

Liquidity Management

Question # 20: It has been suggested that special arrangements such as gates and side pockets should be considered only in exceptional circumstances where the liquidity management process has failed. Do you agree with this hypothesis or do you believe that these may form part of normal liquidity management in relation to some AIFs?

Our answer to this question must be considered with the following background:

- "Special arrangements" should refer to arrangements implemented as a last resort in exceptional and unforeseeable circumstances (such as an international liquidity crisis); they would include suspension of redemptions and side pockets as well as gates but, in the case of gates, only in those cases where the enforcement of gates has not been documented in the AIF's offering documents. By contrast, it is believed that the implementation of suspensions of redemptions as well as side pockets, being tools of last resort whose use should be limited to exceptional circumstances, cannot be viewed as normal liquidity management tools and as a result should not be anticipated in the offering documents of an AIF.
- On the other hand, a gate mechanism which is properly disclosed in an AIF's offering documents should not be considered as a special arrangement but be viewed as a normal liquidity management tool : even in the absence of exceptional market circumstances, the investment portfolio of an AIF may be adversely disrupted by large redemptions, in a way that is detrimental to remaining investors. With a view to ensure the appropriate protection and fair treatment of remaining investors, the inclusion (fully disclosed) of a gate mechanism as part of the normal redemption procedures of an AIF is justified.

In short, a disclosed gate mechanism as a component of an AIF redemption procedures should be viewed as a normal liquidity management tool whereas the implementation, on an emergency basis, of gates that have not been disclosed in the fund's offering documents constitutes a "special" arrangement of the same nature as the suspension of redemptions or the creation of side pockets.

Question # 22: Do you agree with ESMA's proposed advice in relation to the alignment of investment strategy, liquidity profile and redemption policy?

In this analysis, the terms redemption "procedures" are preferable to redemption "policy" which may be considered to be more general and not as specific as actual "procedures". The concern of investors is with the adherence to concrete procedures, properly documented.

The formulation of the advice in box 34 would be more appropriate as follows :

1. (a) in accordance with the AIF documented redemption procedures and its obligations
(b) in a manner consistent with the fair treatment of all investors

NB the fair treatment of all investors is achieved as long as the AIF documented redemption procedures are complied with. In fact, 1. (a) alone, as stated above, is sufficient; 1. (b) becomes redundant.

Paragraph 2. of the proposed advice goes beyond the scope of the directive and should be deleted. It relates to the possible market impact of certain redemptions on certain underlying asset prices and/or spreads. In most cases, it will be highly problematic to anticipate such an impact and the circumstances

where the impact would be materially adverse. The only scenario where such a concern might be valid is that of a large AIF, with a concentrated portfolio representing a significant proportion of a market and/or invested in a market or asset class with insufficient depth. However, (i) this would contravene basic diversification rules, even in the case where the documented strategy of the AIF would anticipate such concentration and large market share and (ii) in the first place, this is an unlikely scenario, as the registration of a fund with such a stated strategy would be withheld upfront by the appropriate national competent authorities.

Delegation

Question # 24: Do you prefer Option 1 or 2 in Box 65?

The words "are not limited to" in Option 2 makes it essentially equivalent to Option 1 but nevertheless less subjective since 4 specific reasons are listed. Hence, a preference for Option 2.

Other comment regarding delegation of portfolio management: a common practice, including in the UCITS universe, is to delegate the management of a part of a portfolio to a non-EU entity that has special expertise in a particular asset class, as, in fact, indicated in item 21 page 128; for instance, in a diversified international equity portfolio, to delegate the management of the US equity component to a US investment manager; such delegation should remain possible. However, box 67 restricts delegation of asset management to entities that are authorized under the UCITS, MIFID or AIFM directives only. Thus, delegation to a US manager would not be possible. This is not in the interest of investors and should be corrected.

Leverage

Introductory remarks:

a) The gross method:

This method grossly overstates the actual leverage of an AIF making use of derivatives, especially in the presence of netting arrangements and hedging arrangements. The resulting numerical level is misleading and of no significance in terms of risk assessment by investors. It would create unfounded investor concerns and would be detrimental to the use of risk management tools and, thus, contrary to investor interests. If the intent of the use of this method is to allow competent authorities to gauge systemic risks in financial markets, then the use of this method should be limited to the reporting to competent authorities but should not be mandatory in the reporting to investors.

b) Regarding the treatment of borrowings:

Clarifications are needed in connection with various statements concerning the inclusion or the exclusion of borrowings in the calculation of exposure. Item 4. on page 199 states that *"So as to avoid double counting, borrowings that have been used to finance exposure should not be included within the calculation"*. On the other hand, item 1. of box 98 page 204/205 states that *"When cash borrowings are invested they have the propensity to increase the exposure of the AIF by the total*

amount of those borrowings.....However, if the cash borrowings are not invested but remain in cash or cash equivalents which remain the base currency of the AIF they will not increase the exposure".
These two statements are not really coherent and need to be reconciled.

Likewise, the third paragraph of item 41. on page 206 is not coherent with item 1. of box 98.:
Borrowing does not necessarily increase the exposure of the AIF if the amounts borrowed are reinvested.... Rather than are not reinvested.

c) Regarding hedging and netting arrangements:

Clarifications are required with respect to paragraph 1. (b) in box 96 about hedging arrangements: *"should not be included in the calculation"* seems to mean that the arrangements meeting the criteria of paragraph 2. should be excluded from the calculation of exposure whereas this paragraph 2. considers that hedging arrangements which meet the listed criteria *"may be taken into account"* in the calculation. It should be confirmed that "taken into account" means "excluded".

On the other hand, it seems incoherent for netting arrangements (which are defined as trades designed to "eliminate" risks as opposed to "offsetting" risks, in the case of hedging arrangements) to be *"included"* at their total combined net exposure, as stated in (c) of paragraph 1. It would seem that netting arrangements should be excluded and not included. Revised wording is called for.

d) Regarding funds of (hedge) funds:

As far as funds of hedge funds are concerned, the prescription of the directive should not attempt to require a look through approach, as it would hit insurmountable methodological problems. Namely:

- (i) a fund of hedge funds, given its professional investor status, is allowed to invest in various funds that are not/will not be subject to the directive,
- (ii) as a consequence, these funds will not calculate their exposures and resulting leverage in keeping with the directive standards nor even in similar ways from one fund to the other.

Thus, it is clear that the lack of identical calculation methods at the underlying funds level will not make it possible to calculate a meaningful leverage on a look through basis.

As an alternative to such approximated and unreliable calculation, an information could be provided to investors, in the fund of funds offering documents/prospectus, of the (approximate) maximum level of leverage of various categories of underlying funds which the AIFM will consider desirable and use as a selection criterion (excluding derivatives equivalent because such information will most likely not be available).

e) Other preliminary comment:

(i) As stated in earlier ESMA workshop papers and discussions, the control of AIF leverage would be best treated at the level of the providers of leverage rather than at the level of the users of leverage (the AIFs). The information would be more readily and quickly available to competent supervision authorities for possible action. As a matter of fact, the providers of leverage are much more concentrated than the users of leverage; the aggregation of users data by supervision authorities is likely to be a very burdensome and lengthy process.

(ii) leverage, as a potential risk factor, can only be assessed in relation to the liquidity of the assets to which this leverage is applied; the same leverage applied to a portfolio of futures contracts and to a distressed debt portfolio does not have the same implications.

(iii) in the case of UCITS Funds of funds, leverage is not considered on a look-through basis.

(iv) existing national regulations concerning the leverage of funds of hedge funds , such as French regulations, cap the leverage of the fund of funds at its own level (10% of net assets in France) rather than on a look-through basis.

Question # 57 : Is further clarification needed in relation to the treatment of contingent liabilities or credit-based instruments:

Yes, see comments above.

Question # 58 : Do you agree that when an AIFM calculates the exposure according to the gross method as described in box 95, cash and cash-equivalent positions which provide a return at the risk free rate and are held in the base currency of the AIF should be excluded?

Yes.

Question # 72 : Does ESMA's proposed advice in relation to the assessment of whether leverage is employed on a substantial basis provide sufficient clarity to AIFMs to enable them to prepare such an assessment?

There is no sufficient clarity when, for instance, reference is made to the contribution of leverage to "the aggravation or downward spiral in the prices of financial instruments or other assets in a manner which threatens the viability of these prices" (see 2. (e) in box 110 page 240). A "downward spiral in the prices of financial instruments" may be caused by many factors other than the unwinding of "substantial leverage"; for instance, all overbought positions are not necessarily financed through the use of leverage. In other words, to establish or assume a causal relationship with leverage and declining prices is a debatable proposition, hard to substantiate in many circumstances. The depth and liquidity of an asset or asset class are factors of greater concern although the built up of leverage can be a factor of aggravation.

Depositories

Question # 25: How difficult would it be to comply with a requirement by which the general operating account and the subscription/redemption account would have to be opened at the depository? Would that be feasible?

The experience, in France, is that the opening and operation of these two accounts at the depository not only is not difficult, but is a simplifying mode of operation. See also answers to question 29 below.

Question #29: Do you prefer option 1 or option 2 in Box 76?

Option 2 is preferred and, in practice, the only reasonable approach when considering hedge funds. In Option 1, the “mirroring” in a hub of all transactions in all cash accounts that may be opened by the AIF would raise considerable if not insurmountable problems in terms of information flows and controls. NB this also addresses Question #28 : the proposed advice would present difficulties in connection with accounts opened by a hedge funds at several prime brokers or counterparties (other than the depository and which or may not provide custodial services), such multiple prime broker or counterparty relationships being a common practice in the hedge funds universe.

Question # 33: Under current market practice, which kinds of financial instrument are held in custody (according to current interpretation of this notion) in the various member states?

This question raises, indirectly, the question of instruments held in custody versus held in record keeping and the attendant question of the liability of a depository in connection with the recording of an AIF investment in a *nominee* account, as raised also in question #36. The same instrument, depending on how it is recorded by the depository could be viewed as held in custody or held in record keeping.

Transparency

Question # 64: In general, do you agree with the approach presented by ESMA in relation to remuneration? Will this cause issues for any particular types of AIF and how much cost is it likely to add to the annual report process?

On the one hand, the presentation in each individual AIF annual report of the AIFM's aggregate amount of remuneration is irrelevant and of no use to pass a judgment on the risk taking of such individual AIF, even when considering items (iii) and (iv) of point 27 page 227.

On the other hand, the presentation of remuneration drilled down to the individual AIF level will involve a methodology developed by each AIFM and thus will not result into any meaningful comparisons.

The ultimate added value, to investors and competent authorities, of this proposition, however well intended, will be limited, if any at all.

Question # 66: Do you agree with ESMA's proposed definition of special arrangements? What would this not capture?

In our views, to consider any type of gates as “a special arrangement”, in the same category as side pockets, is inappropriate. A distinction should be made between (i) gates that are formally recorded in an AIF's offering documents (as a regular liquidity management tool) and (ii) gates that are not

recorded in an AIF's offering document and are set up on an emergency basis because of exceptional circumstances. This second type of gates merits to be analysed along side pockets as tools of last resort.

On the other hand, gates that are properly documented in the AIF rules, instruments of incorporation and/or prospectus are legitimate on going liquidity management tools, in the interest of investors, when they are established with a view to avoid the de-structuration of a portfolio as a result of an important redemption level, which can occur in the absence of exceptional (market) circumstances. ESMA's proposed definition does not recognize the difference between exceptional circumstances and the need, in the investors' best interest, to exercise an orderly control over large redemptions (in normal market circumstances). This said, in both cases, it is justified to request the disclosure of the level of assets subject to special arrangements or the impact of gates on redemptions.

Question # 67: Which option for periodic disclosure of risk profile under box 107 do you support?

Option 1 is preferred as it does not raise the many methodological issues that option 2 would inevitably entail : measures used to assess the sensitivity to various risks, assumptions regarding stress tests, etc.

Person to contact for any inquiry: Mr Christian Bartholin
Member of the Executive Committee
cbartholin@hdf-finance.fr
tel +33 (0)1 44 17 12 51