

To : **Committee of European Securities Regulators/
European Securities and Markets Authority**

Re: **Call for Evidence – Implementing Measures on the AIFM Directive**

Please find below contributions* from **HDF Finance** (Paris).

* limited to issues most relevant to its business

Introduction : Who is HDF Finance?

- HDF is an independent French asset management firm created in 1986 and based in Paris, with subsidiaries 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 Luxemburg (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 to hedge funds or funds of hedge funds (“ hedge fund type AIF” or “hedge fund AIF”, from hereon).**

NB Comments provided below relate, in the case of each “Issue”, to the topics that are underlined.

Issue #2 (Article 9) Initial capital and own funds

The concept of “additional own funds appropriate to cover potential liability risks arising from professional negligence” does not lend itself to any clear definition: (i) how to assess the degree of “potential liability”, (ii) how to determine “professional negligence”? It is recommended to set aside this provision.

Issue #5 (Article 15) Risk Management

Our comments about this issue must be viewed in light of our belief that a clear managerial and functional distinction is needed between (i) risk management (a responsibility of portfolio management officers) and (ii) risk control (a responsibility to be discharged by an officer, or a unit, independent of the portfolio management line). Different systems and/or tools may be needed by these different parties. It is not possible to design a meaningful “one-size fits all” risk management system for all types of hedge fund type AIF.

However, a general principle is that each AIFM should maintain a documented risk management policy, including a mapping of risks involved with each AIF under management and the risk monitoring instruments used.

1.a) The key risks that must be managed and controlled include the following :

- (i) market risk
- (ii) interest rate risk
- (iii) liquidity risk
- (iv) volatility risk
- (v) currency risk
- (vi) credit risk
- (vii) leverage risk
- (viii) counterparty risk
- (ix) operational risks
- (x) risks that are specific to certain investment strategies, such as, for instance : credit spreads, country/sovereign risks, corporate events, correlation risks, etc.

It can only be up to each AIFM to identify, measure, manage and control such risks. Beyond such general categories of risk, it is also useful to identify the “embedded” or “hidden” risk factors to which a fund performance is sensitive in practice, regardless of the risk parameters formally stated in the AIF documentation itself; specialized non-linear risk models can be of help in this respect.

Thus, in practical terms, it is recommended to focus on risks (i) to (ix) above.

1.b) Methods for quantifying and measuring risks:

- The variety of risks listed above make it clear that each type of risk requires specific analytical tools. Although many of the above listed risks are qualitative in nature, the AIFM should strive to set quantitative limits for each category of risk, whenever possible.
- A further step is to assess the probability distribution of the risk parameters and the correlation of risks.
- Scenario based tools may be useful to evaluate the effects of one or a combination of risks in extreme events (stress tests).

1.c) Methods for managing and monitoring risks so that the AIF risk exposures are consistent with the overall risk objectives of the AIF:

- a basic requirement is to perform risk monitoring at regular intervals, such as, at least, at each valuation date. Shorter time intervals, depending on the strategy involved, might be warranted such as the minimum holding period of each trade, the time horizon of trade financing or the term of commitment of margin requirements, etc. but such other intervals will be hard to discriminate.
- risk monitoring should be performed by a party functionally independent from the portfolio management line.
- the duties of this independent risk control function should be formally documented; this document should include a description of actions to be taken when risk limits are breached.

2. Appropriate frequency of review of the risk management system: Annual

3. Appropriate risk management governance: As indicated above, a basic requirement is for the portfolio management function and the risk control function to be entirely separated.

4. Proportionality principle:

The risk control function, irrespective of how it is performed, must be separated from the investment management line, regardless of the size of the AIFM. This said, for AIFM with assets below €200 million, it is conceivable for the risk control function to be performed by a senior officer of the AIFM on the basis of properly developed risk control policy and procedures. Above €200 million, a dedicated risk control officer or committee or an external third party is deemed appropriate.

6.b) Criteria to be used by competent authorities when assessing whether the risk associated with each investment position of the AIF and their overall effect on the AIF's portfolio can be properly identified, measured, managed and monitored on an on-going basis, including through the use of stress testing:

Firstly, the notion of risk assessment in connection with **each** position of an AIF portfolio (i) is not meaningful and (ii) is unlikely to be achievable in the case of certain strategies used by hedge fund type AIF. It is not meaningful inasmuch as positions may be correlated or netted; it is unlikely to be achievable in practice in the case of strategies involving a high turnover of positions, such as systematic trading or high frequency trading strategies for instance.

What is meaningful to understand and monitor, from an investor point of view, is:

- the above listed risks (i) to (ix) at the portfolio level, or
- the above listed risks (i) to (ix) at the strategy level.

Second, the notion of monitoring **on an on-going basis** has no applicability in the case of many hedge fund strategies that are prone to involve a high rotation level in their portfolios.

Thus, in practical terms, it is recommended to consider criteria (a) related to risks at the portfolio or strategy level and (b) applicable at intervals corresponding to the stated valuation cycle of the AIF.

6.d) Criteria to be used in assessing whether the risk profile of the AIF corresponds to the size, portfolio structure and investment strategies and objectives of the AIF as laid down in the AIF rules or instruments of incorporation, prospectus and offering documents:

The definition of a general “risk profile” is highly subjective unless it is reduced to a quantifiable measure, as done in the case of the UCITS KID where it is synthesized in the form of a volatility measure. Likewise, any assessment of an actual risk profile against a proposed risk profile as stated in the AIF documentation is equally subjective unless a quantifiable measure is used.

Thus, in practical terms, if the notion of “risk profile” is thought to be relevant across the spectrum of AIF, it is recommended to make use of the same criterion as that retained in the UCITS KID: volatility. This will address the question of “criteria” to be used.

NB the question of leverage is discussed in Issues #19 & 23 (definition and control of leverage)

Issue #6 (Article 16) Liquidity Management

As stated in Article 16.2 itself, the most basic applicable principle regarding liquidity management, is to ensure at all times a realistic matching between the redemption terms of the AIF and the liquidity of its portfolio of assets. References to the UCITS directive is unfounded because of both the different financial instruments involved and different investors involved.

1. Content of rules that are proportionate and necessary for specifying the general obligations to monitor the liquidity risk of the AIF:

The most obvious rule required here is simply a re-statement of the above principle itself.

2.a) Systems and procedures to be implemented by the AIFM to monitor the liquidity risk of the AIF:

The most basic and most useful tool required is a liquidity run-off schedule, based on the liquidity of individual portfolio assets under normal market conditions. Using the same tool, portfolio liquidity can be simulated under various hypotheses of stressed market conditions. The liquidation of positions may involve specific costs which must also be taken into account.

2.b) The content of the obligation for the AIFM to conduct stress tests:

Stress tests must be based on circumstances of severe market disruptions. It is important to specify the assumed market scenarios and/or make reference to specific earlier market disruptions.

2.c) The circumstances under which the investment strategy, liquidity profile and redemption policy of an AIF can be considered to be consistent.

Under normal market conditions, a first approach to ensure the above consistency is the implementation of standard redemption terms involving an advance notice period corresponding to the average liquidity of the asset portfolio. However, this will not be sufficient in the event of large redemptions; with a view to avoid the de-structuring of portfolios in such circumstances, differentiated advance notice periods can be defined according to the size of redemptions.

However, at times of severe market disruptions, such rudimentary matching and differentiated advance notice periods will not suffice. In order to address such low probability but high stress situations, an AIFM can also define, in the AIF documentation, redemption terms involving a gate mechanism when redemptions, on a given NAV date, exceed a defined percentage of the AIF net assets.

Redemption fees applicable in certain circumstances are another redemption policy tool to be considered.

Keeping in mind that AIF are directed at professional investors, redemption mechanisms do not have to be regulated as such but they have to be clearly defined in the AIF documentation.

Issue #8 (Article 18) General Principles

Requirements applied to AIFM in respect of human and technical resources, organization, administrative and accounting procedures, data processing, internal control, compliance, operations processing, personnel policies, etc. should be identical to requirements defined in the UCITS directive (and no more extensive, keeping in mind that AIF are directed at professional rather than retail investors).

Issue #9 (Article 19) Valuation

As it is recognized by the directive that the valuation process can be conducted externally or internally as long as it is functionally independent from the portfolio management unit. Situations where valuation is conducted by a dedicated entity distinct from the AIFM but belonging to the same group as the AIFM are deemed as acceptable and should be so viewed under the directive (subject to the eligibility requirements set by the directive).

The professional guarantees expected to be provided by an external valuer will differ according to the type of AIF involved. Technical expertise in a given AIF category, human resources and financial stability should be key selection criteria.

Technical expertise requirements for an external valuer should include: (i) having direct access to the AIF counterparties and (ii) having the capability to source asset prices independently from the AIFM.

The frequency of valuation for open-ended funds is a function of the assets held by the fund and its issuance and redemption frequency (weekly, monthly, quarterly NAV trading dates etc.); however, estimated NAV can be released, for information purposes, at shorter intervals.

The integrity of the valuation process can be enhanced through the disclosure of the degree of reliance on the AIFM rather than on independently sourced prices (as a percentage of the AIF assets). This information could be reported in the form of an average percentage in the AIF annual report.

Issue #10 (Article 20) Delegation of AIFM functions

Provisions regarding delegation in the AIFM directive should not be more extensive than those included in the UCITS directive, keeping in mind that the former is directed at professional investors rather than retail investors.

Depository (Article 21)

General comments:

- 1) The role and responsibilities of the depository will differ according to the type of AIF involved.
- 2) It is essential to recognize that the single depository requirement, if ultimately enforced across the full range of AIF, must, at a minimum, remain compatible with the existence of multiple prime brokers. However, it must be emphasized that the concept of a single depository, in the case of hedge fund AIF, has numerous limitations and drawbacks.

The concept of a single depository is supposed, generally speaking, to provide better control and transparency. However, with respect to hedge fund AIF, in practice, it has significant detrimental side-effects as it is likely to lead to an undesirable concentration of counterparty risks and thus aggravate rather than reduce systemic risks.

As a matter of fact, the standard practice for hedge funds, especially large hedge funds, is to deal with several prime brokers to diversify credit and other counterparty risks. It is also unlikely that a single depository bank will have the competence or the willingness to negotiate multiple prime brokerage agreements, repurchase agreements, ISDA agreements,

etc. the likely outcome will be an undesirable concentration of risks, inducing more rather than less systemic risks. Another related side effect will be an equally undesirable reduction of competition between banks (and prime brokers).

Because of the operational complexities resulting from having a single depository, this requirement, if enforced un-discriminately, will have the unintended consequence to deter the creation and domiciliation of hedge funds in Europe, contrary to the ultimate objective of the directive.

Issues #12 (Article 21) Depository – Criteria for assessing equivalence of the effective prudential regulation and supervision of third country depositories

At a minimum, a depository:

- must be subject to a specific set of regulations (banking or otherwise)
- regulations must be enforced by a well defined supervisory body with sanction powers.

The release by ESMA of a list of countries meeting these regulatory and supervisory requirements is called for, to avoid interpretation issues at the national supervisory level.

Issues #13 (Article 21) Depository – Depository functions

Standard prime brokerage practices involve the use of financial instruments as collateral or the re-use of these instruments. In such circumstances and as a general rule, legal title is transferred. Such practices must be preserved. Contracts (i) between the AIF (or AIFM acting on behalf of the AIF) and the depository and (ii) between the depository and prime brokers (if both players are involved) should provide for such circumstances. Investors should be informed of such arrangements in the AIF constitutional documents.

Issues #14 (Article 21) Depository – Due diligence requirements

The delegation by the depository of some of its functions to a third party (prime broker, sub-custodian) must (i) be performed on the basis of a documented procedure and (ii) the latter must be made available to the AIFM. Contracts between a depository and a delegated third party must be provided to the AIFM for its review and acceptance. The contract established between the AIFM and the depository must provide for such delegation.

Issues #15 (Article 21) Depository – Segregation obligation

In the case of delegation to a third party, in order to ensure that segregation is maintained at all times by such third party:

- the contract between the depository and the third party should make the segregation obligation a binding condition
- the depository should, at appropriate intervals, perform direct checks or request an audit firm's confirmation that segregation is properly maintained.

Issues #17 (Article 21) Depository – External events beyond reasonable control

The notion of "loss as a result of an external event beyond (the depository's) reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary" has and will always have subjective dimensions.

In order to reduce the level of subjectivity and facilitate the interpretation of the notion, it is recommended to ensure, in the first place, that the respective on-going responsibilities of the depository and the third party involved are well defined in the contract binding the two parties. An "external event" can then be assessed, with less difficulty, against the responsibilities

listed in the contract. “Reasonable control” and ‘reasonable efforts” will however remain subject to a case by case analysis.

In an attempt to define “external events beyond reasonable control”, a contract may include reference to (among other circumstances) “force majeure”, “government decisions” or “acts of God”.

Issue #19 (Article 4) Definition of Leverage

General comments:

a) The concept of leverage has no significance in the absolute. It is meaningful only in relation to the liquidity of the assets on which leverage is applied. A leverage of 10/15x in the context of a futures portfolio is not worrisome given the high liquidity of the futures markets. On the contrary, a leverage of 2x for a portfolio of distressed debt is probably quite risky.

b) It must be recalled that UCITS funds, although directed at retail investors, are allowed to make use of different types of derivatives with embedded leverage but are not required to report such type of leverage as such (other than through the VAR based leverage measure); a more detailed form of leverage reporting for funds directed at professional investors is not justified.

c) Contrary to popular belief, many hedge funds (especially long/short equity funds) employ a limited amount of leverage (rarely exceeding 3x for this category of funds).

d) To the extent that the hedge funds leverage is viewed as a potential source of global systemic risk (which remains to be demonstrated), the more meaningful and workable way to monitor leverage is not by consolidating data at the AIF level but at the level of the providers of leverage ie the counterparties to AIF, such as prime brokers and banks (see comments in Issue #23)

Leverage being defined as “any method by which the AIFM increases the exposure of an AIF”, it is necessary to identify the most commonly used methods. The first basic distinction is between : (i) cash borrowings/bank loans/debt issuance, (ii) repos and (iii) derivatives (futures, options, CFD, warrants, various hybrid instruments, etc.)

Given the complexity of defining rules (i) for the calculation of the embedded leverage in these various products and (ii) for aggregating such calculations, it is recommended to analyse *qualitatively* the above 3 sources of leverage (when warranted) and resort, as in the case of the UCITS regulations, to a VAR based leverage measure. Such information should be disclosed in the AIF periodic reporting, at a minimum on an annual basis.

It is not recommended to translate derivative exposures into notional amounts as identical notional values may be misleading when concerning instruments involving different levels of risk and therefore different cash outcomes.

Issue #20 (Article 22) Annual report content

The following items should be included in annual reports:

- a summary review of the AIF investment strategy, changes from the year earlier, if any
- changes in the risk profile of the AIF, if significant
- an information concerning assets subject to special arrangements due to their illiquid nature (side pockets, write downs) as a percentage of total AUM, compared to the year earlier

situation; together with an assessment of likely future developments :
improvements/deterioration

- changes in arrangements for managing the liquidity of the AIF (redemption policy, redemption/penalty fees, gates, side pockets, etc.)
- a breakdown of assets and liabilities and changes from the year earlier; positions in excess of 5% of total portfolio
- realized and unrealized capital gains and losses, compared to the year earlier
- an income statement with key income and expenditures accounts, compared to the year earlier
- usual expense ratios
- full year total subscriptions and redemptions
- the audit of the financial statements by an audit firm with proper expertise in the strategy practised by the AIF
- any event having occurred after the year end with a significant impact on the management and financial position of the AIF

Regarding the remuneration of the AIFM staff members, and subject to the application of the proportionality principle stated in the recent CEBS Guidelines on Remuneration Policies and Practices, the annual report can be supplemented with remuneration disclosure: fixed and variable total remuneration, number of beneficiaries with a breakdown into (i) senior management and (ii) staff with a material impact on the risk profile of the AIF.

Issue #21 (Article 23) Disclosure to investors

Inasmuch as funds subject to the AIFM directive are funds directed at professional investors, it is not justified to impose general disclosure requirements beyond those required from funds subject to the UCITS directive which are primarily intended for retail investors. However:

a) Regarding leverage, and as there can be several forms of leverage, it is best to address this question through a requirement for the AIFM to define (in the AIF documentation) (i) the form of leverage used and (ii) the maximum authorized level of such leverage. The definition of leverage, as well as the existence of a right of re-use, should be part of the AIF constitutional documents made available to investors. See also answers to Issue # 19 above.

b) Regarding liquidity, it is appropriate to disclose (on a semi-annual basis, in line with interim and full year financial statements) the percentage of assets subject to deteriorated liquidity instituted by the underlying managers of these assets (as a result of market developments or otherwise) on a basis not defined in the initial constitutional documents.

Issue #22 (Article 24) Reporting obligations to competent authorities

Inasmuch as funds subject to the AIFM directive are funds directed at professional investors, it is not justified to impose reporting requirements beyond those required from funds subject to the UCITS directive which are primarily intended for retail investors.

Regarding leverage and liquidity, see answers to Issue #21 above.

See also answers to Issue #23 below.

Issue #23 (Article 25) Use of information by competent authorities, supervisory cooperation and limits to leverage. Systemic risk.

Circumstances in which competent authorities shall exercise the powers granted pursuant to Article 25 (3). Leverage limits.

As indicated earlier, there has not been any conclusive evidence so far that the use of leverage by hedge fund type AIF is a source of systemic risk, contrary to the systemic risk inherent in the banking sector. The issue is all the more difficult as leverage (i) takes different forms and (ii) cannot be assessed in the absolute but only in relation to the liquidity of the assets to which leverage is applied, as already mentioned above in Issue #19. Any general regulation of leverage at the AIF level that does not recognize this diversity is bound to create inconsistencies, be over-restrictive in some cases and superfluous in others.

Hedge fund type AIF are directed at sophisticated investors and it is unlikely that large scale defaults of hedge funds can be a source of systemic risk through their investors, as suggested by the limited fall out of the demise of Amaranth, Bayou, Manhattan or even LTCM, not to mention the Madoff case, which happened to be a fraud and not a defaulting hedge fund.

On the other hand, it is conceivable, but far from certain, that a large hedge fund or a group of hedge funds defaulting on the same counterparties may breed a systemic risk through transmission by these counterparties. Banks and prime brokers, as providers of leverage, are therefore the entities that (i) need to manage their exposures to hedge funds and (ii) need, in turn to be monitored regarding these exposures from a systemic risk standpoint. Thus, it appears that the Basel process is a much more relevant forum to address this issue than the AIFM directive as such. History shows that defaulting bank counterparties are clearly a more significant source of systemic risk, as illustrated by the Lehman Brothers failure, than the impact of defaults by individual hedge funds on these same bank counterparties.

Inasmuch as the AIFM level 1 directive implies that controls over leverage at the AIF level must be considered in *certain* circumstances, the following tentative indicators are suggested:

- (i) circumstances when such controls will be applied should be outlined, such as clear evidence of asset price bubbles, market corners, etc.
- (ii) large hedge funds only should be subject to such controls, “large” being defined as a hedge fund with a size, in a given strategy, exceeding, say 10%, of the overall strategy considered, and
- (iii) any control or limitation should take into account the liquidity of underlying assets.

Again, a more meaningful and practical way to control leverage is to exercise this control at the level of the providers of leverage (banks, prime brokers), rather than the users (AIF). It must also be kept in mind that AIF are required (at least in some EU countries) to state in their prospectuses or bye-laws, the maximum level of leverage authorized by virtue of national regulations. Such policy makes it possible for regulators exercise control over leverage, on an ex-ante basis.

To what extent the following aspects might endanger the stability and integrity of the financial system:

a) Leverage used in different strategies and the size of an AIF “footprint”

As indicated above, hedge fund AIF cannot be viewed as a source of systemic risk transmitted through their investors. They may be a source of such risk through their

counterparties if the latter do not properly monitor their own exposures (as providers of leverage) and are improperly regulated. This risk can be alleviated through the use of multiple depositories and prime brokers.

b) Concentration of risks in particular markets and risks of spill over effects:

The single depository requirement, through the inherent consequence of concentrating risks, is prone to aggravate spill over effects rather than reduce them. A sound policy for depositories and prime brokers is to ensure that they deal with a diversified range of AIF that have uncorrelated returns in order to reduce their own financial risks.

c) Evolution of prices of assets with respect to their fundamentals

Excessively accommodating monetary policies usually lead to inflationary pressures in certain asset classes, such as equities, bonds, real estate or commodities. The transformation of certain types of assets (for instance, commodities) into “asset classes” by institutional investors can also increase the volatility of prices.

Several hedge fund arbitrage strategies are based on the “mean reversion” principle and can benefit from this volatility but, conversely, underlying arbitrage activities tend to dampen drifts away from fundamental values. Other strategies, the long/short equity and credit strategies, play an even more significant and very beneficial role in the evolution of prices. Short selling, although commonly vilified, contributes heavily to the prevention and reduction of asset price bubbles; indeed, short selling plays a useful contrarian role against the occurrence of excessive price levels away from intrinsic asset values. Short selling provides a message : its growth, at times, is the symptom of excessive price levels rather than a cause of price declines. The message should not be confused with the messenger.

It is worthwhile to note that the worst asset bubbles develop in markets where there is no or limited short selling activity, such as in the real estate or credit sectors. It is also worthwhile to remember that, in the fall of 2008, the bans of the short selling of financial stocks did not stop the fall of bank share prices, as those were just fundamentally overpriced.

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