BG/EP/SJ – n° 2283/Div.

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IOSCO General Secretariat
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Spain

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Re: AFG's comments on IOSCO's Call for views on issues that could be addressed by IOSCO on funds of hedge funds

Dear Ms. Vulpes,

The Association Française de la Gestion financière (AFG)[1] would like to thank IOSCO and the members of Standing Committee 5 ("SC5") for the work that they have carried out in producing the *Consultation Report on Calls for views on issues that could be addressed by IOSCO on funds of hedge funds* and welcomes the opportunity to comment on the Report.

<u>AFG's responses to the series of questions:</u>

[1] The Association Française de la Gestion financière (AFG)[1] represents the France-based investment management industry, both for collective and discretionary financial portfolio managements. Our members include 365 management companies and 772 investment companies. These management companies are entrepreneurial or belong to French or foreign banking, insurance or asset management groups. AFG members are managing more than 2500 billion euros in the field of investment management, *making the French collective investment fund industry the leader in Europe* (with nearly 1500 billion euros managed, i.e. 22% of all EU investment funds assets under management, wherever the funds are domiciled in the EU) *and the second at worldwide level after the US*. In the field of collective investment, our industry includes – besides UCITS – the employee savings scheme funds and products such as regulated hedge funds/funds of hedge funds, private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the International Investment Funds Association (IIFA).

1. Regarding the risk monitoring by the manager of a fund of hedge funds, what disclosure standards could regulators promote in relation to the information about that monitoring? In particular, what information could be provided to retail investors? Please, explain your comments.

We think that adequate regimes should be put in place for alternative investment strategies that do not (or do not yet) fit with the normal investment fund regimes (UCITS III in Europe or “OPCVM à vocation générale” in France).

The general idea is that these “alter-UCITS” should be subject to lighter regulations on the fund itself but also that the fund managers should prove their ability to manage and indeed to monitor the risks of the very innovative techniques they use.

Investors, whether institutional, high net worth or mass affluent as today, or maybe retail tomorrow as these techniques gradually go mainstream, should be, as for all investment funds, made aware of the risk/return objectives of the funds and of the fact that they are managed by regulated and closely monitored asset management firms.

That is the efficient path the French legislator and regulator have chosen when they decided to authorize French ARIAs and contractual funds. Such an approach has been very successful since the launching of on-shore French hedge funds and funds of hedge funds in 2004, as in 2006 French on-shore funds of hedge funds were already representing around 30 billion euros under management (with a regular yearly growth, e.g. 63% in 2006).

We do think that the European Union at least should follow that route and promote European “alter-UCITS” regime and brand.

2. Regarding the investment strategies that are carried out by a fund of hedge funds (including the underlying funds’ strategies), what disclosure standards could regulators promote in relation to the information about those strategies? In particular, what information could be provided to retail investors? Please, explain your comments.

For retail investors, we think that the most important elements to disclose are:

- The fund of funds strategy (for instance: multi-strategies such as 1/3 event driven 1/3 long-short 1/3 market neutral; sectorial such as 100% long-short, etc.);
- Whether the strategy is absolute return or directional;
- The expected return;
- The expected volatility.

There is yet an un-conclusive discussion on the necessity – or not - that managers should disclose more precisely the asset class of the underlying of underlying funds (funds of hedge funds country X large caps for example), especially for directional funds.

3. Once an investor has purchased the units/shares of a fund of hedge funds, what information should be delivered to him on an ongoing basis and how frequently? Please, explain your comments.

It should be delivered to him the same type of information as the one he would have had if he had purchased units of a "classical" fund.

As far as we know, institutional investors negotiate the reporting they want on a case by case basis. They can choose different ratios, risk-indicators, frequency of reporting, etc. We do not think that disclosing the name of underlying funds could be helpful for investors. Investors choose to pay the funds of funds' manager precisely because he has the appropriate human and technical skills for finding the appropriate funds.

4. With regard to the first approach, what criteria for the eligibility of underlying funds would be appropriate or necessary?

The large majority of AFG's members is in favour of a principle-based approach.

5. With regard to the second approach and jurisdictions that authorize fund managers, what should the regulator consider with respect to the manager's due diligence process (*e.g.*, types of controls, etc.) and in which cases could the fund of hedge funds' manager be deemed responsible? Please, explain your comments.

From our point of view, regulators should promote managers' regulation and therefore authorise fund managers' activity on the basis of a relevant, public, well designed set of due diligence, which must be approved and regularly monitored by regulators.

These different points should be included into minimum due-diligence promoted by regulators and implemented by funds of hedge funds' managers:

- Assessment of underlying's legal structure
- Assessment of underlying's manager human and technological abilities
- Assessment of underlying's strategy
- Assessment of underlying's risk management
- Assessment of underlying's valuation process

Of course, a principle-based approach is also consistent with the first approach. When assessing an HF legal structure, the fund of funds' manager should also include the issue of money laundering.

6. How should regulators approach the use of target performance by funds of hedge funds? If funds of hedge funds disclose different performance targets, will investors be able to assess the performance targets? Does the comparison of a fund's performance with a benchmark assist investors in assessing performance targets? Please, explain your comments.

We do not think that a clear-cut answer can be given to that question. The most common performance target used by absolute return funds is a free-risk rate plus a few basis points (such as LIBOR + xxx bps). Most of the time, a volatility target is also disclosed to investors.

The question is the lack of homogeneity between this type of benchmark and the universe the manager invests in. Some absolute return products are positively correlated with stock markets and then there is a beta effect when investors thought they were invested in a pure “alpha” product. Therefore the question of a relevant benchmark is crucial.

One solution could be the use of ratios such as Sharpe ratio, Sortino ratio, Omega ratio, etc., in addition to the performance target disclosure, even if we are aware of the limits of these ratios.

Another solution could be the comparison with alternative indices. However, the lack of representativity and of homogeneity between funds, funds of funds and “financial” indices could lead investors to misunderstand the risks and returns of their investments.

This is a crucial topic that needs more in-depth discussion.

7. Given the potential multiplicity of fee layers in the case of funds of hedge funds, how should the regulatory framework handle the fee and expenses issue? Are the general IOSCO principles sufficient to address this issue in the case of funds of hedge funds investing in other funds of hedge funds?

As a total disclosure of underlying’s fees is neither relevant nor realistic from an operational point of view, the principle should be that the investor must have a clear vision and understandable information on all fees at the fund of funds’ level.

Concerning the question of funds of funds of funds, this topic is currently discussed in France with the view that a total ban is not a desirable outcome. We will send our remarks as soon as the industry will have fully settled a position at domestic level.

8. What regulatory responses would be necessary to deal with the potential conflicts of interests arising from fee sharing agreements between the bottom-tier fund and the top-tier fund?

This question is not specific to FoHFs.

9. Should there by limits or conditions on the extent of “overlay” that a fund of hedge funds could do to avoid a fund of funds from making excessive direct investments (and acting like a single hedge fund). If so, what limits or conditions should there be?

N/A

10. Should regulators recommend or require minimum levels of diversification and concentration (e.g., limits of number of underlying funds and maximum percentage of fund value invested in each underlying fund or funds with the same strategies), and, if so, what minimum levels? Please, explain your comments.

It depends on the investor's ability to well understand risks.

For "sophisticated" investors, it could make sense to have large exposures on few underlyings. If strategy, risks, low diversification are clearly disclosed, we do not think that regulators have to set up recommendations about the minimum level of diversification.

For retail investors, studies show that around 10 funds could adequately diversify market risk. Then the minimum level of diversification should be recommended around 10 funds. We are aware of the discussion around operational risk diversification. But a "naive" diversification approach would require including a lot of funds, resulting in over-diversification (with re-correlation problems etc.). Due diligence is an absolute requirement prior to investment. The more funds you have in your portfolio, the less time you have to investigate each individual fund and so the more risks you have to invest in a fund with lower operational standards.

As we have already said, adequate due diligence should be the aim of each manager and should be the regulatory pre-requisite for the funds' manager to be authorised to manage their funds.

11. Should fund of hedge funds managers be encouraged or required to have facilities (*e.g.,* credit facilities) for the purpose of meeting any redemption requests, and, if so, how should fund of hedge fund managers be encouraged to have such facilities? In what circumstances could the fund of hedge funds be allowed to suspend and/or postpone redemptions? Do funds of hedge funds present other liquidity issues for retail investors? Please, explain your comments.

Liquidity issues should be understood as the question of asset/liability adequacy. The aim is to protect investors who stay in the fund whereas other investors are closing their position.

In case of important redemptions, this asymmetry may conduct the manager to sell less liquid assets insofar that price may dramatically decrease. It could impact the fund of funds NAV but also the pricing of other financials instruments and especially the NAV of other funds with the same strategies or the same underlying funds.

From our point of view, gates may solve this problem. Regulators should accept this optional mechanism, which permits to postpone a % of the redemption to the next NAV.

Of course, the use of gates should stay exceptional and never become a common management technique.

We want to stress that this mechanism will avoid systemic risk and will protect investors who want to stay invested in the fund.

12. What are the common ways in which funds of hedge funds purchase, sell or redeem their interests (*e.g.,* listed on an exchange, periodic repurchase offers, and redemption)? Please, explain how valuation issues affect funds of hedge funds and investors based on how the funds' share interests are offered and sold.

N/A

13. Would it be appropriate to require or recommend frequency of valuation for the underlying hedge funds (monthly, for instance), and, if so, what minimum frequency would it be appropriate to require or recommend? Please, explain your comments.

As far as it is the fund of funds' manager job to assess his asset/liability adequacy, we do not share IOSCO's views on valuation frequency requirements.

The French regulation allows, rightly in our view, for a 60 days period between repurchase "cut off" and the fund of funds NAV computation (NAV establishment date being included in this timeframe). Based on the feedback of French funds of funds' managers, it ensures that the computation of funds of funds NAV is made with nearly 90% of hedge funds administrators NAV. For the remaining 10%, *ex post* difference between estimated NAV and final NAV is, in most of cases, not relevant.

14. How should the manager of a fund of hedge funds address discrepancies in the timing of valuations between underlying funds and the fund of hedge funds? Please, explain your comments.

N/A

15. What level of due diligence concerning the underlying funds' NAV calculations can the fund of hedge funds be expected to perform? What specific due diligence concerning the underlying funds' NAV calculations should the fund of hedge funds manager carry out?

Valuation is one of the most crucial topics for funds of funds' managers. As we have already stressed, due diligence concerning valuation must be clearly disclosed to investors and regulators. It must be a regulatory pre-requisite for the authorisation of the management activity.

16. Does the use of leverage present unique issues for funds of hedge funds? Should regulators promote particular standards to address leverage in the specific context of funds of hedge funds (*e.g.*, borrowings and/or exposure through the use of derivatives and other financial instruments, exposure through underlying hedge funds), and, if so, which standards? What kind of disclosure standards would be necessary to ensure an appropriate level of information on the total amount of leverage accessible to a fund of hedge funds? Please, explain your comments.

The scope of questions concerning leverage is far larger than the area of funds of funds.
It is therefore not relevant to deal with this subject in this call for views. We will be happy to discuss this question in a specific and larger consultation including fund managers' views, prime brokers' views and other market players' views.

17. What standards and rules should regulators consider to address the suitability of the sale of funds of hedge fund interests to retail investors? Please, explain your comments.

N/A

18. What best practices could be formulated at the international level regarding the due diligence process to be performed by the manager of the fund of hedge funds? Please, explain your comments.

IOSCO should take into account the AIMA's and other trade associations' best practices of due diligence.

19. What level of transparency concerning the underlying funds is required for managers to conduct their due diligence? What level of transparency concerning the underlying funds should be required for managers to conduct adequate due diligence? Is a similar or different level required for investors? Along with the role of transparency in the top tier manager's due diligence, what other issues does transparency raise, e.g. for the underlying funds?

N/A

20. Are side letters common among funds of hedge funds? Do side letters raise concerns for managers and investors in funds of hedge funds, and if so, how should those concerns be addressed?

N/A

21. How common is delegation and what sorts of functions are typically delegated in connection with funds of hedge funds? Should regulators address delegation (including the scope of delegations, identity and competence of the delegation), and, if so, how? Should certain delegations be prohibited?

We are in favour of two types of delegation:

- Delegation of operational due diligences to entities such as lawyers, auditors etc.
- Delegation of financial management, but restricted to regulated managers.

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If you wish to discuss the contents of this letter with us, please contact myself at 01 44 94 94 14 (e-mail: p.bollon@afg.asso.fr), Stéphane Janin, Head of International Affairs Division at 01 44 94 94 04 (e-mail: s.janin@afg.asso.fr) or Bertrand Gibeau, Management Techniques Advisor at 01 44 94 94 31 (e-mail: b.gibeau@afg.asso.fr).

Yours sincerely,

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