



SJ – n° 2553/Div.

Mr Greg Tanzer  
Secretary General  
International Organization of  
Securities Commissions  
C/ Oquendo 12  
28006 Madrid  
Spain

30 April, 2009

Re: ASSOCIATION FRANCAISE DE LA GESTION (AFG)'s comments on IOSCO  
Consultation Report regarding Hedge Funds Oversight

Dear Mr Tanzer:

The ASSOCIATION FRANCAISE DE LA GESTION (AFG)<sup>1</sup> would like to thank IOSCO for having solicited comments on its Technical Committee Report on Hedge Funds Oversight.

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<sup>1</sup> The Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. Our members include 409 management companies and 660 investment companies. They are entrepreneurial or belong to French or foreign banking or insurance groups.

AFG members are managing 2400 billion euros in the field of investment management. In terms of financial management location, it makes the French industry the leader in Europe for collective investments (with 1300 billion euros managed by French companies, i.e. 23% of all EU investment funds assets under management, wherever the funds are domiciled in the EU) and the second at worldwide level. In terms of fund domiciliation, French funds are second in Europe and third at worldwide level. Regarding product interests, our association represents – besides UCITS – the employee saving scheme funds, hedge funds/funds of hedge funds as well as a

## General Comments

Although we recognise the value of the IOSCO Report, we are very surprised that from a Regulators' perspective some dimensions are not stressed at all in the Report.

**1.** The Report does not mention enough as a starting point that regulators have very often in their official status a requirement to ensure investor protection. This issue of investor protection is mentioned only in two of the eleven questions of the report.

Indeed, this goal should be the driving line around the world for regulatory reflections on all financial products – including hedge funds.

**2.** The Report does not sufficiently stress the fact that the dichotomy “wholesale investors” versus “retail investors” is a fiction more and more today. From a general perspective, the recent financial crisis showed clearly that such a dichotomy is not relevant: at the end of the day, the end retail investor gets the yield but also has to bear the losses (e.g. retirees of pension funds, tax payers of bankrupted local or regional authorities, etc). In addition, as rightly mentioned in the Annex 5, p. 63, by the UK FSA, and as we have kept saying it for several years, high net worth individuals represent today approximately only 20% of hedge fund assets as compared to institutional investors acting on behalf of third parties which represent 80% of hedge fund assets. The UK FSA stresses that in particular retail customers have indirectly access to hedge funds through institutional investors such as pension funds.

**3.** On this basis, and considering the current general wish expressed all over the world to restore investor confidence, regulators have to make sure that investor protection is fully taken into account, including when professional investors act on behalf of end investors.

**4.** In our view, requiring due diligence from professional investors is not enough. Obviously, such due diligence must be done – and for instance investment managers in France are already required to perform it – but this is not enough. Considering the Madoff case (or the Amaranth case in the past), the issue is not only to require the respect of the rules but also to make sure that, as an investor, you have a reasonable chance to get your money back through a legal action, in case of violation of the rules or the contract by the hedge funds manager, the prime broker, the depositary, the valuator....

**5.** From this perspective, this Report is too much focused on the obligations to be applied by the Management Company as compared to the other crucial elements of the hedge fund chain:

- offshore domiciliation versus onshore domiciliation of the fund: what will happen if the investor (e.g. a pension fund) wants to go to a court located in another part of the world?

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significant part of 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 European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

The retiree must have a minimum confidence that legal action can be effective – which is very uncertain if fund jurisdictions are located offshore. Apart from pure financial risks, offshore hedge funds embed an additional and crucial risk, i.e. the *legal risk* in case of needs of legal prosecution after an hedge fund failure;

- the rest of players involved, in particular the prime broker and the depositary, should be appropriately regulated (as in particular they deal with the financial flows and custody of assets – to give them back to investors in case of failure of the fund).

6. Last, regarding Annex 5, we deeply regret that some national regimes are not mentioned, such as for instance the French regime, although France is the second hedge fund industry in the European Union.

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### Detailed comments

#### Chapter 1: overview of risks posed by hedge funds to capital markets – lessons drawn from the financial crisis

Q1 p. 16: we think that the FSF work should not overstate the issue of remuneration and compensation. In many cases, managers are interested in the performance of their funds, which incites them to act in the interest of all investors and not against it.

Q2 p. 20: No, Chapter 1 does not appropriately identify and describe the relevant risks associated with hedge funds and their operations. It mainly identifies the *macro-economic/systemic risks* related to hedge funds (markets, trading, etc) *but not the micro-economic risks borne by end investors. In particular, it does not mention at all the legal risks associated to investments done in offshore places, with difficulties to act in justice in offshore jurisdictions* when investors want to get their money back.

#### Chapter 2: Overview of the current level of regulation of hedge funds and Chapter 3: Preliminary conclusions and possible recommendations

Regarding Chapter 2, we contest the presentation made on p. 29 between “CIS-like regulatory approach” and “Registration requirements for managers and advisers”. Although IOSCO mentions that in certain cases a combination of approaches can be observed, we think that this combination is not stressed enough. Wherever the cursor is put on the balance regarding such a mixed product/player approach, the vast majority of jurisdictions apply such a mix. Therefore the presentation by IOSCO appears somewhat misleading. It is only in Annex 3 p. 43 that IOSCO mentions (IOSCO 2006 Report) that many IOSCO members regulate both the hedge fund adviser and the hedge fund itself.

Regarding the preliminary conclusions and possible recommendations:

### Hedge Funds counterparties – Prime Brokers and Banks:

Q. 1 p. 33: From a prudential risk perspective, we agree that regulators should obtain information from prime brokers and banks on their hedge fund counterparties. We also agree for strong risk management controls at prime brokers and banks, as long as these risk management controls are proportionate.

### Hedge Fund Managers:

Q. 1 p. 33: We contest the formulation of the question by IOSCO, as it mixes both investor protection and systemic risk concerns. Regarding systemic risk concerns, we agree that direct regulation of hedge fund managers is probably the best approach, in addition to the monitoring of prime brokers and banks – which bear the financial risk from a systemic perspective. But regarding investor protection concerns, IOSCO misses one crucial point: ensuring the legal safety of investors, by recommending the on-shore domiciliation of hedge funds as compared to offshore domiciliation. From this latter perspective, regulation of managers is necessary but not enough. In particular, an easy access to court at the fund domicile must be ensured – which is less easy – to say the least – in the case of offshore domiciliations as compared to onshore ones.

Q. 2 p. 33: As above, we don't contest that there is a need for a consistent regulatory approach to hedge fund managers, but first this consistent regulatory approach must apply to the whole chain of players involved (prime brokers, depositaries, valuers in particular) and second this approach on players will not be enough and should be complemented by a minimum approach on funds themselves, by clearly differentiating offshore funds and onshore ones – as the degree of risk is not the same for investors in the two types of funds.

Q. 3 p. 33: Regarding a regulatory oversight based on risks focused on systemically important hedge fund managers, we think that once again IOSCO is mixing the macro-economic/systemic risks of hedge funds and the micro-economic risks borne by end investors. We agree with IOSCO that – if we just speak about systemic risks, this suggestion makes sense. But at micro-economic level, this risk-based approach centred on the most important players does not make sense: at micro-economic/investor level, the regulatory approach must apply to all players and hedge funds, whichever their size is.

Q. 1 p. 34: Regarding registration/authorisation of managers, we agree with the proposed list of information to be provided at authorisation/registration. However, we think that investors should be provided with adequate transparency not only on the business of the hedge fund manager, but also on the prime brokers, the depositaries, the auditors and the implications of the domiciliation of the related fund.

Q. 1 p. 36: Regarding ongoing monitoring/supervision, we agree that it would be appropriate for regulators to require hedge fund managers to set up a comprehensive and independent risk management function, a strong independent compliance function, a robust calculation and/or verification of fund valuations, an independent audit of fund accounts, conflicts of interest rules,

adequate compensation/remuneration structures and practices as well as transparency vis-à-vis regulators. Even more importantly, regarding another item mentioned by IOSCO, i.e. adequate segregation and protection of client fund assets, we contest the fact that it is put under the responsibility of the fund manager: it must be the responsibility of the regulator to ensure this, and it should be directly required from custodians and depositaries. Once again, we have the feeling that IOSCO is only dealing with hedge fund managers – and put (legitimate) duties on them – without putting the same level of duties on the rest of players involved (prime brokers, depositaries in particular). In particular, there is no mention of the risks associated to the possible offshore domiciliation of the funds, and/or depositaries or valuers, although the main regulators do take them into account. For instance, the UK FSA recognises the limits of its action when dealing with offshore hedge funds from this perspective. UK FSA wrote in p. 63 of the IOSCO report that *'funds are generally located off shore and therefore outside of their regulatory remit'*. French based hedge funds are subject to stringent rules and their managers are rightly not authorized to safe keep the assets of the funds they manage.

#### Hedge Funds:

Q. 2 p. 36: As already mentioned above, we think first that systemic risk and investor protection concerns must be differentiated. Regarding systemic risks, it could make sense to request managers to disclose their whole portfolios, wherever the funds are domiciled. But from an investor protection perspective, we need a mix of regulation both on managers and on the funds themselves: mainly based on managers (and the rest of the players involved) but with also a differentiation between onshore and offshore-domiciled funds. The onshore domiciliation of the fund would allow for active marketing in the country of domiciliation, while offshore funds could be spontaneously subscribed by investors but not actively marketed as their associated legal risks would be, by far, higher than those for onshore domiciled funds.

#### Industry Best Practices:

Q. 1 p. 37: Best practice standards can bring some thought to regulators (including IOSCO). But we fully agree with IOSCO that there is a big issue if professionals do not comply with the standards. For instance it appeared that even the IOSCO Code of Conduct for Credit Rating Agencies (CRAs) was not complied by CRAs and finally led to the reinforcement or the setting up of legislation in different parts of the world. Once again from an investor perspective, standards are useful and necessary but cannot be a substitute for legislation. The best solution is to find an appropriate balance between legislation and professional codes.

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We thank you in advance for your attention to the views expressed above.

If you wish to discuss the contents of this letter with us, please contact myself at +33 1 44 94 94 14 (e-mail: [p.bollon@afg.asso.fr](mailto:p.bollon@afg.asso.fr)) or Stéphane Janin, Head of International Affairs Division at +33 1 44 94 94 04 (e-mail: [s.janin@afg.asso.fr](mailto:s.janin@afg.asso.fr)).

Sincerely,

Pierre BOLLON