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Gaëtan previously worked in the Issuer Department at the AMF, which regulates listed entities, where he was in charge of authorising complex products with a notes wrapper and debt issuance programmes of financial institutions and corporates.

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How to address regulatory risks and challenges posed by hedge funds?

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How to address regulatory risks and challenges posed by hedge funds?

- I. Legal or regulatory definition of hedge funds
- II. What type of risks do they pose?
- III. Regulatory responses to these risks and challenges
 - ▶ IOSCO final report on Hedge Fund Oversight
 - ▶ Regulations in the US and in Europe
- IV. Consistency of the different regulatory approaches?

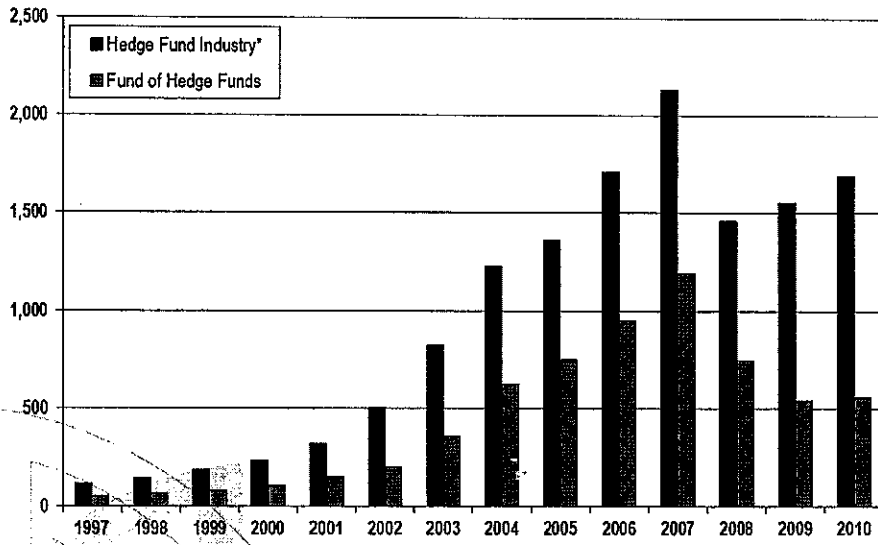
I. Legal or regulatory definition of hedge funds (1/4)

- No comprehensive, uniform and universally accepted definition of this type of investment vehicles
- Hedge funds encompass a wide (heterogeneous) range of investment objectives, strategies, styles, techniques and assets under management, therefore offering a wide spectrum of risk/return profiles
- However there exists some common characteristics...
 - The main characteristic of hedge funds: they are more flexible in terms of investment options than traditional collective investment schemes as hedge funds' managers generally have no or very limited restrictions on the use of various active investment strategies to achieve positive absolute returns (uncorrelated)
 - Traditional investor base = qualified / professional investors
 - High minimum investment threshold (for instance, USD 1 million)
 - Investors usually have limited access to liquidity after "lock-up" period
 - They have, in the past, often been closed-ended vehicles
 - Many are based in offshore jurisdictions for tax consideration

I. Legal or regulatory definition of hedge funds (2/4)

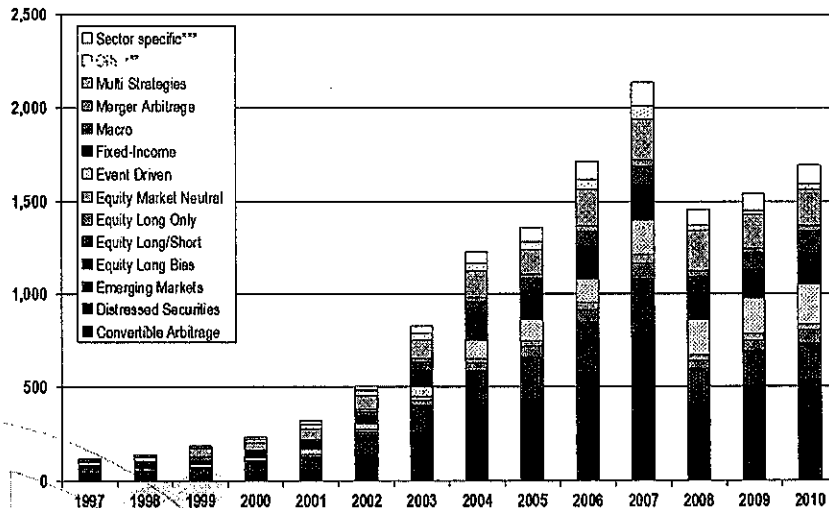
- ...and some working descriptions
 - ECB used a working definition of EU hedge funds in its November 2005 survey: "a fund, whose managers receive performance-related fees and generally have no or very limited restrictions on the use of various active investment strategies to achieve positive absolute returns. Such strategies often involve leverage, derivatives, long and short positions in securities or any other assets."
 - IOSCO's TFUE report on Hedge Fund Oversight (June 2009) "[...] hedge funds [...] all those investment schemes displaying a combination of some of the following characteristics:
 - borrowing and leverage restrictions, which are typically included in collective investment schemes related regulation, are not applied, and many (but not all) hedge funds use high levels of leverage
 - significant performance fees (often in the form of a percentage of profits) are paid to the manager in addition to an annual management fee
 - investors are typically permitted to redeem their interests periodically, e.g., quarterly, semi-annually or annually
 - often significant own funds are invested by the manager
 - derivatives are used, often for speculative purposes, and there is an ability to short sell securities
 - more diverse risks or complex underlying products are involved

I. Legal or regulatory definition of hedge funds (3/4)



* Excludes Fund of Funds assets
Source: Barclay Research - February 2011

I. Legal or regulatory definition of hedge funds (4/4)



** Other: include funds categorized as Regulation D, Equity Short/Bias, Option Strategies, Mutual Fund Timing, Statistical Arbitrage, Closed-End Funds, Balanced, Equity Dedicated Short and without a category.
*** Sector Specific: includes sector funds categorized as Technology, Energy, Bio-Tech, Finance, Real Estate, Metals & Mining and Miscellaneous oriented.

Source: Barclay Research - February 2011

II. What type of risks do they pose? (1/3)

- As a result of their investments, hedge funds may, like any other operator or investor in the financial markets, pose a source of systemic risk in relation to financial stability (credit channel) and market efficiency (market channel)
 - Risks for financial stability: given their lack of transparency regarding their operations and investments (as they wish to keep their management secrets confidential), regulators (notably prudential ones) globally miss the relevant data to be in a position to assess the potential impacts and risks resulting from their operations (for instance, the extent of their counterparty risk)
 - Risks for market efficiency/performance:
 - What would happen if all the elephants ran to the exit at the same time?
 - Importance of their activities and operations globally and the related risks and in particular, the importance of their footprints (i.e., the total value of all their long and short securities positions), the wide range of trading and investment strategies used, and of the markets concerned by their investments

⇒ However, this does not mean that hedge funds alone automatically lead to systemic risk

II. What type of risks do they pose? (2/3)

- Risks for individual (non-professional) investors as there exists various forms of retail access:
 - Indirect exposure
 - Development of funds of hedge funds
 - "Relaxation" in certain jurisdictions of the limits on distribution of single hedge funds or fund of hedge funds to the public
 - Listing
 - Retailing of products which exhibit hedge fund-like characteristics or based on underlying hedge funds => a blurring borderline between hedge funds and European UCITS

II. What type of risks do they pose? (3/3)

- Operational risks and quality of administration, notably the question of hedge funds' assets valuation / custodian
- Hedge funds and corporate governance models

III. Regulatory responses to these risks and challenges (1/10)

- Crucial that hedge fund regulation be undertaken on an international basis in consideration of the business models currently used by hedge funds and their geographical location (often in offshore countries)
- The G20 declaration of 2 April 2009:
 - *"Hedge funds or their managers will be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators, including on their leverage, necessary for assessment of the systemic risks that they pose individually or collectively. Where appropriate, registration should be subject to a minimum size. They will be subject to oversight to ensure that they have adequate risk management. We ask the FSB [Financial Stability Board] to develop mechanisms for cooperation and information sharing between relevant authorities in order to ensure that effective oversight is maintained where a fund is located in a different jurisdiction from the manager."*

III. Regulatory responses to these risks and challenges (2/10)

- Today several international initiatives to regulate hedge funds to support the G20 declaration to restore global growth and achieve reforms in the world's financial systems
 - At the IOSCO level: the final report on Hedge Fund Oversight which was released on 22 June 2009 and which provides for six high level principles designed to assist securities regulators in addressing the regulatory and systemic risks posed by hedge funds in their respective jurisdictions pursuant to a consistent global framework
 - In the US: the "*Dodd-Frank Wall Street Reform and Consumer Protection Act*" which was enacted on 21 July 2010 (the Dodd-Frank Act) and to enter into force in July 2011 (for the most part)
 - In the EU: the Directive on Alternative Investment Fund Managers (AIFMD) which was adopted by the European Parliament on 11 November 2011 and which should enter into force in 2013

III. Regulatory responses to these risks and challenges (3/10)

A focus on the US: the Dodd Frank Act (Title IV thereof)

- Its principal provisions concerning to hedge funds' managers relate to:
 - Registration and reporting requirements
 - Financial stability and prudential risk regulation (e.g., establishment of a Financial Stability Oversight Council (FSOC))
 - The "Volcker Rule"
 - Investor protection measures
 - Regulation of OTC derivatives

III. Regulatory responses to these risks and challenges (4/10)

A focus on the US: the Dodd Frank Act (Title IV thereof) (followed)

- **Removal of the “private adviser exemption”** which allowed exemption from registration for any US resident adviser (i) having fewer than 15 clients in the preceding 12 months, (ii) not holding itself out to the public as an investment adviser, and (iii) not acting as an investment adviser to a registered investment company or a business development company
 - => under this exemption, each private fund (e.g., hedge fund, private equity fund) qualified as a single client regardless of the total number of investors investing in it
 - => many investment advisers with large amounts of assets under management and numerous investors did not have to register with the US SEC

- **Creation of 3 new (non mandatory) exemptions from registration:**
 - (i) Advisers solely to private funds with less than USD 150 million in assets under management in the US
 - (ii) Advisers solely to “venture capital funds” (whatever the number or the size of such funds) as defined by the US SEC (e.g., not leveraged, contributing substantial capital to early-stage companies, no redemption rights offered to investors)
 - (iii) “Foreign private advisers” with no place of business in the US, with less than US\$ 25 million in aggregate assets under management from US clients and private fund investors, with fewer than 15 such clients and investors, and which do not hold themselves out generally to the public in the US as an investment adviser nor acts as such to a registered investment company or to a business development company

III. Regulatory responses to these risks and challenges (5/10)

A focus on the US: the Dodd Frank Act (Title IV thereof) (followed)

- ⇒ These exemptions are not mandatory (managers qualifying for any exemptions could choose to register or remain registered with the US SEC (subject to the 1940 Investment Advisers Acts which generally prohibits registration by managers that do not have at least USD 100 million in assets under management)

- ⇒ Implementation rules have been elaborated and submitted to public consultation by the SEC

- ⇒ A manager benefitting from these exemptions from registration with the SEC may nonetheless be subject to registration by one or more State securities authorities

III. Regulatory responses to these risks and challenges (6/10)

A focus on the US: the Dodd Frank Act (Title IV thereof) (*followed*)

- Once registered with the US SEC, investment managers/advisers:

=> Have to comply with different requirements notably in relation to Reporting (e.g., ADV form) and Recordkeeping of information/data pertaining to:

- The amount of assets under management
- The Use of leverage, including off-balance-sheet exposures
- The Counterparty credit exposure
- The trading and investment positions
- The trading practices
- The Valuation policies and practices
- The types of assets held
- The side letters giving certain investors more favorable rights
- And any other information determined by the SEC

=> May be subject to inspections by the US SEC

III. Regulatory responses to these risks and challenges (7/10)

A focus on the EU: the AIFMD

- On 1 May 2009, the European Commission (EC) published the AIFMD proposal to regulate managers of alternative investment funds (e.g., hedge funds) as opposed to the funds themselves
- AIFMD entry into force: 2011 (expected to be adopted by the European Council in 2011 after being adopted by the European Parliament on 11 November 2010)
- Implementation into Member States' national law: 2013 (*i.e.*, 2 years after entry into force of AIFMD)
- To that end, ESMA is currently working on numerous implementing measures (*i.e.*, regulatory technical standards (RTS) and implementing technical standards (ITS)) pursuant to the EC's mandate

III. Regulatory responses to these risks and challenges (8/10)

A focus on the EU: the AIFMD (*followed*)

- **Its scope: managers satisfying the following conditions:**

- they conduct their activity in the EU (whatever the country of domicile of the funds they manage)
- they manage funds which are NOT UCITS (e.g., hedge funds, private equity funds, real estate funds)
- they manage directly or indirectly a portfolio of more than EUR 100 million or EUR 500 million (in the case of unleveraged funds that may not be redeemed for a period of 5 years following the date of initial investment)

=> AIFMD does not as such apply to "small" managers, its initial objective being the regulation and oversight of alternative investment funds' activities likely to cause systemic risk

III. Regulatory responses to these risks and challenges (9/10)

A focus on the EU: the AIFMD (*followed*)

- **A two-fold purpose:**

- (i) to enhance the transparency of managers and of the funds they manage towards supervisors, investors and other key stakeholders
- (ii) to set up an harmonized European framework for alternative investment funds to regulate all major sources of risks and in particular:
 - **Authorization and on-going obligations** upon managers (e.g., appropriate governance standards, robust systems in place for the management of risks/liquidity/conflicts of interest, minimum capital, disclosure obligations vis-à-vis investors and competent authorities)
 - **Obligations upon key service providers** notably valuers and depositaries (as regards their legal status, domicile, regulation and supervision)

III. Regulatory responses to these risks and challenges (10/10)

A focus on the EU: the AIFMD (*followed*)

- **Provision of a European passport allowing managers to market funds to professional investors throughout the EU subject to specific conditions:**
 - ⇒ For European funds: upon the AIFMD entry into force (2013)
 - ⇒ For third country funds: 2 years after the AIFMD entry into force subject to the ESMA's positive advice and the EC's decision (so that this passport could be granted as from 2015)
 - **Requirements that funds' managers' set up and maintain remuneration policies and practices which are:**
 - consistent with and promote sound and effective risk management
 - appropriate to the managers' size, internal organisation, and the nature, scope and complexity of their activities
- ⇒ These requirements are fully in line with the EC recommendation of April 2009, and the G20 Final Statement

IV. Consistency of the different regulatory approaches? (1/4)

- **Today's hot topic:** have recent events (e.g., the 2007 market turmoil, the Madoff affair, and the Lehman Brothers collapse) urged on jurisdictions to set up consistent legislative and regulatory frameworks?
- **Any encouraging signs of consistency among regulations worldwide?**
 - From a global perspective, the financial reforms underway appear consistent with one another => they share the same objective of a strengthened and more appropriate regulation
 - However, when one looks more closely into the provisions of such financial reforms, this *prima facie* consistency is not that clear
- **An illustration of the inconsistency in the approaches to regulation throughout the jurisdictions:** some examples drawn from the Dodd-Frank Act and the AIFMD

IV. Consistency of the different regulatory approaches? (2/4)

With regard to the exemptions provided to the benefit of funds' managers

- The Dodd Frank exemptions: are structured in such a way that in practice, they only benefit to a minority of managers (for ex., the newly introduced "foreign private adviser" exemption provides for such a low threshold regarding the aggregate assets under management attributable to US clients/investors (i.e., USD 25 million) that a majority of funds' managers will not be in a position to benefit from it. Hope that the US SEC which has the authority to change this threshold will increase it`
- The AIFMD exemptions: appear more straightforward and apply equally to European and non European managers without discriminating against non European managers as they do not refer to the nationality of the clients whose assets are being managed but focus on amount of assets under management (thresholds of EUR 100 million or EUR 500 million (in case of unleveraged funds that may not be redeemed for a period of 5 years following the date of initial investment))

IV. Consistency of the different regulatory approaches? (3/4)

With regard to the obligations of reporting on systemic aspects

- From a general perspective, the reporting obligations under the Dodd-Frank Act and the AIFMD globally seem to cover the same items
- In practice, both the US agencies and the ESMA could adopt a similar approach as regards implementing measures by imposing reporting forms inspired from IOSCO questionnaire in relation to the 2010 hedge fund survey
- However, they appear not to refer to the same frequency nor to the same threshold. for example, the reporting obligations under the Dodd-Frank Act may require the largest managers (above USD1bn AuMs) to provide extensive data several times a year whereas the reporting obligations under AIFMD may be imposed on the managers complying with authorisation thresholds)
 - If there were two different reporting approaches, they would be:
 - burdensome, costly and time-consuming for managers operating both in the US and in the EU and having to register with two different regulators
 - far from being helpful and efficient for the supervision and monitoring of risks notably systemic ones and the gathering and consolidation of data at international level

IV. Consistency of the different regulatory approaches? (4/4)

- How to promote consistent approaches to regulation throughout jurisdictions?
 - A challenge for regulators given the major risks for the investors and the industry that might result from **regulatory inconsistency: regulatory arbitrage and systemic risk**
 - To that end, IOSCO decided to review and strengthen the governance of its Standing Committees and Task Forces so as to **further stimulate and increase the promotion of consistent approaches to regulation among the IOSCO membership** => preliminary initiatives appear quite fruitful

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Questions?

Thank you for your attention