



AIMA RESPONSE TO THE EC HEDGE FUND EXPERT GROUP'S REPORT OF JULY 2006

Introduction

The Alternative Investment Management Association Limited ("AIMA") is - some 16 years after its establishment - the only global, not-for-profit, professional trade association representing the hedge fund industry. It is also the only such association which represents all practitioners in the alternative investment management industry - whether managers of hedge, futures or currency funds or those providing other specific services such as prime brokerage, administration, legal or accounting, auditing and tax advisory services.

Its membership is corporate and now, comprises, globally, over 1,050 firms, approximately 60% of which are based in Europe. AIMA's growth has been commensurate with the development of the hedge fund industry worldwide.

The three 'pillars' of AIMA are education, regulation and sound practices. AIMA's objectives specifically include increasing investor education and the use and application of transparency, best practices and due diligence in the industry, as well as the promotion of the responsible development of alternative investments. AIMA seeks to ensure the representation and integration of skill-based investments in mainstream investment management and works closely with national securities' regulators, other interested regulatory and fiscal bodies, investors and all parties to achieve its objectives.

Overview

In its Response below, AIMA seeks to present a balanced view, which takes into account the thoughts, comments and opinions of our European membership as a whole. On the areas where our members hold divergent views, we have attempted to reflect these different concerns. With in excess of 1,000 corporate members, it is surprising, perhaps, not that there are differences of opinions on some aspects of the Expert Group's Report but, rather, that there is such unanimity of views on many of the eleven Recommendations made.

It is clear that there are different avenues which have been opened, along which the alternative investment sector in Europe might develop. We believe that whatever solution that may be ultimately proposed should not be to the exclusion of those vehicles which are already

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accessible to the professional and/or retail investor within different European Member States (such as listed funds in the UK or ARIAs in France). Such vehicles play their own and important role within the development of the industry as a whole.

AIMA recognizes and applauds the progress that has been made by regulators in several Member States in allowing products on-shore within their jurisdiction, as well as the willingness of other regulators to open their markets to the benefits of all investors concerned. We particularly wish to acknowledge the openness of the European Commission and its Asset Management team and its willingness to look at the landscape and barriers to development and to work with the industry to find solutions.

Over the past twenty (and more) years, the European Hedge Fund Industry has made remarkable progress. The industry has established a wealth of experience and expertise and, whilst complacency is always to be avoided, it has an extremely good track record, with extremely limited, if any, experience of fraud and wider market misconduct. The European hedge fund industry has been given a "clean bill of health" by several experienced regulatory authorities within the European Union which have worked hard to open their markets to hedge funds and have established efficient and respected regulatory environments, which AIMA recommends other regulatory authorities (such as the SEC) might consider recognizing and adopting.

The economic benefits of the alternative investment industry within Europe are properly reflected in the Expert Group's Report and by regulators (see, for example, the comments of the UK's FSA in their Discussion Paper 05/4 "Hedge Funds: A Discussion of Risk and Regulatory Engagement"). AIMA believes that the concerns which the Expert Group raises are not solely hedge fund issues but rather, they apply to all investment products - whether managed by a traditional asset manager or a manager from the Alternative Investment sector. The industry should be looked at in its entirety and developed responsibly and not piecemeal.

It is AIMA's belief, as set out in our Response below, that the ultimate aim of future regulation, as reflected in recent European directives, should be to move away from the regulation of the product and towards ensuring that the distribution of the product is properly regulated, efficient and suitable to the investor's needs. We see no logic in the position whereby a retail investor is denied the ability directly to invest in hedge funds but is able to gain access through different structured vehicles. This point is well brought out within the Expert Group Report. However, it is not realistic to believe that such a change can happen immediately; rather, AIMA's wish would be for the overall change to distribution regulation to occur with due caution and consideration over an appropriate period of time.

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AIMA's Response to the EC Expert Group Report

Recommendation 1

Member States should recognise the broadening investor appetite for hedge funds and related products by developing a regulatory approach that is compatible with these needs and the organisation of the hedge fund business.

The Group recommends that European authorities and supervisors allow the provision of investment services in respect of the full range of hedge funds and related products by investment firms authorised in accordance with MiFID - without imposing additional restrictions or formalities at the level of the fund, its manager or other participants in the value chain.

In particular, the Group recommends that regulators do not seek to control sales and distribution through product regulation or registration. The Group is of the view that regulators should focus, instead, on two levels of protection:

- first, the Group recommends that conditions be introduced to prevent access to hedge funds by investors for whom such investments are not suitable. A majority of Group members considered a minimum threshold of 50'000€ would satisfy this condition. A substantial minority considered that a higher threshold and/or other safeguards should apply;
- second, the Group recommends the enforcing of clear conduct of business requirements on the intermediaries and institutions who conclude sales contracts with end-investors. This is an appropriate and efficient means of providing the graduated level of protections required by different investor categories.

We believe that this recommendation was put forward by the Expert Group in lieu of a European private placement regime and was intended to be analogous to a 'qualified investor' regime. In doing so, the Expert Group favours provisions which already exist under both MiFID and the Prospectus Directive.

However, it may prove that the Recommendation is premature since there is still a great deal of uncertainty as to how MiFID will be finally interpreted by and implemented within the various Member States.

The idea of regulation of funds through the imposition of appropriate requirements on the distributor, rather than on the product, appears to be the way forward, provided that this change is introduced with due caution and consideration and over an appropriate length of time.

Some of our members agree with the Recommendation and believe that a move away from product regulation and to reliance on a mixture of disclosure and conduct of business rules, in accordance with MiFID, is to be preferred. They suggest that the best solution would be to build upon MiFID definitions of 'complex' and 'non complex' products and to allow a fund to be developed in either category and, accordingly, to be subject to the relevant conduct of business requirements attached to that category.

However, AIMA accepts that hedge funds cannot expect more favourable treatment than other investment funds.

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Recommendation 2

The majority of the Group recommends against reopening negotiations on the key provisions of the UCITS Directive with a view to facilitating the authorisation of a broad range of funds of hedge funds as UCITS. A minority considered that the time was right to broaden investment rules and other provisions of the UCITS directive to allow funds of hedge funds to be authorised as UCITS compliant funds.

A number of our members would like to see funds of hedge funds qualify for authorisation under UCITS III, provided that the characteristics of hedge fund investing are fully recognised. AIMA recognises that UCITS III allows certain "hedge fund like" products and that steps are being taken to bring more flexibility to UCITS products - as highlighted in the 'Investment Fund Market Efficiency' Expert Group's Report.

Anecdotally, as the limitations of such a poll have to be taken into account, AIMA has recently conducted a poll of members, asking the following question:

"Would you like to see a pan-European UCITS-style 'passport' for hedge funds, enabling easier cross-border distribution?"

The poll took place during September 2006, 164 responses were received, as follows:

Yes	82%
No	12%
Don't know	6%

The question posed was primarily intended to refer to funds of hedge funds, although it is recognised by many that a properly diversified hedge fund utilising one of the more mainstream strategies could also qualify.

Recommendation 3

The Group recognises the potential value in allowing retail investor access to hedge fund based investing by authorising UCITS to invest in derivatives on hedge fund indices. However, the majority of the Group recognises the validity of concerns regarding the reliability and functioning of hedge fund indices. The Group, with exception of one member, recommends that UCITS investment in derivatives based on such indices be deferred until concerns regarding the structure and performance of hedge fund indices are resolved.

We agree with this Recommendation and we offer AIMA's assistance to CESR on further consideration of this possibility.

Recommendation 4

Whilst concerned about the limitations associated with product regulation, the Group recommends that the European institutions and national authorities take all non-legislative steps needed to give effect to the mutual recognition of (nationally regulated) retail-oriented hedge fund products. These should be mutually recognised as suitable for sale to the investing retail public across the European market and for distribution under MiFID conditions. This should not be considered as a substitute for other reforms suggested with regards to improving the distribution regime for non-retail oriented funds.

This Recommendation ties in with the UCITS framework. It extends to open-ended funds - under the private placement provisions available under the Prospectus Directive exemptions - and AIMA endorses this recommendation.

For ease of reference, we set out here the full text of the report in respect of this Recommendation (to be found at page 22 of the Report):

"... whilst some Member States have created certain locally supervised products, they do not extend similar marketing possibilities to comparable products authorised under other Member States' rules.

In particular, several Member States have authorised the sale of funds of hedge funds to retail investors on the grounds that they provide diversified exposure to this asset class. This has been the case, for instance, in France, Germany, Ireland, Luxembourg and Spain. Whilst there are concerns regarding the level of product regulation that some of these regimes introduced, the Group welcomes this approach and believes funds of hedge funds (or well diversified hedge funds) could provide significant benefits to a wide range of investors for whom the case may be that investment in offshore or traditional hedge funds is not appropriate.

Mutual recognition of nationally authorised hedge funds would be a logical extension of single market principles to products which are explicitly designed and authorised with the retail investor in mind and would dovetail with the full implementation of MiFID. It would recognise, moreover, that retail investors already enjoy indirect access to hedge fund investing through structured products and securities issued by listed closed-end hedge funds. Certain Member States already implement such a practice, whereby they allow the marketing to their retail investing public. Group members believe that the hedge fund industry could be allowed to use these national concepts to build a retail investor base across the single market. Building on the mutual recognition principle would allow the cross-border marketing of such products without the need for the painstaking and unproductive harmonisation of product features.

Whilst concerns were noted about the risk of product regulation, which is evident in some national Member State hedge fund regimes to date, the Group was in favour of progressing towards mutual recognition of hedge fund products which have been authorised for sale to retail investors under different national regimes. Provided that the distributor is regulated under MiFID and acquits all his duties of care, these products could then be sold to retail investors on a cross-border basis. Recognition should be extended to the organisation of the participants to the value chain as they are registered

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with Member State authorities. However, the Group is of the view that mutual recognition must not be viewed as a substitute for the other reforms proposed, for example, making the existing regimes for cross border sales to institutions and sophisticated investors (who are likely to require products that would not qualify for mutual recognition) less restrictive.”

However, AIMA would also stress that a number of its members are not in favour of any cross-border promotion of existing products which can be sold to retail investors, for a number of reasons:

- minimum investment limits are one of the key issues. Unless a common minimum investment limit is set for all funds of hedge funds, there will be opposition from countries that do not offer similar products;
- a Member State may have specific structures or approaches to take into account: this is an opportunity however, for national regulatory authorities to focus on market efficiency and competition;
- as the Recommendation itself points out, serious discrepancies currently exist: in some Member States, there is no specific regulation allowing the marketing of funds of funds to retail investors, who can gain access to hedge funds through structured products (protected notes, unit linked, index linked etc). In the case of Italy, for example, while a structured note linked to hedge funds may be marketed by an Irish or Luxembourg entity, an Italian asset manager cannot do likewise. Clearly, this creates barriers for local investors and industry alike.

Recommendation 5

Regulators and industry bodies should remove absolute or arbitrary quantitative restrictions on hedge fund based investing which are imposed on some institutional investors. The Group advocates removal of any arbitrary and/or regulatory prohibition or restriction. The "prudent man" principle which informs the Directive on the activities and supervision of institutions for occupational retirement provision (IORP) should be more broadly applied. AIMA fully endorses this Recommendation. We note that the "prudent man" principle referred to within the Recommendation is also noted with approval in the report by the 'Private Equity Expert Group' (at page 22 of that report).

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Recommendation 6

The Group recommends that effective steps be taken to ensure a measured and appropriate implementation of the Capital Requirements Directive - one which does not result in exaggerated and prohibitive restrictions on bank investment in hedge funds. The European Commission and Committee of European Banking Supervisors should, at an early stage of the implementation of the Basle II framework, compare and reconcile the trading book rules in each Member State as well as how they are construed and applied by the competent supervisory authorities. Guidance is particularly needed in respect of the level of transparency that regulators should require when allowing banks a more favourable "look-through approach".

In addition, the Group recommends that the European Commission provide for appropriate provisioning requirements under its forthcoming proposals for Solvency II. The forthcoming draft Directive should not impose excessively onerous reserve requirements which would represent an unjustified deterrent to investment in hedge funds by life-insurers.

AIMA endorses this Recommendation as consistency and clarity in this area are necessary.

Recommendation 7

The Group urges the European Union and national authorities to enter into negotiations with the US Securities & Exchange Commission and other relevant parties with a view to securing exemption from the US registration requirements for European hedge fund managers who are already registered with a Member State authority and are doing business with US qualified investors. If new regulations are put in place due to the US Court of Appeals decision, the Group urges the European Union Commission to make appropriate comments and to enter into negotiations so that the final regulations that are put in place do not have adverse consequences for the European Hedge Fund industry and to specifically ensure that no dual registration is required for managers already regulated in Member States.

AIMA endorses this recommendation and will be meeting the SEC and US legislators at the end of September to discuss the position of non-US hedge fund managers already regulated in European jurisdictions and will make further representation for the SEC to recognise those jurisdictions.

AIMA encourages the EC and CESR to support this initiative.

Recommendation 8

An absolute requirement for a local entity to perform custody functions for European hedge funds does not significantly increase the level of investor protection available above that required by such sophisticated hedge fund investors; in reality it restricts the ability of managers to generate returns which in turn impedes the ability of the European hedge fund industry to grow and compete in the global market place. Such requirements also prevent the provision of cross border services by custodians in other Member States and stifle competition. Member State regulators should not impose a requirement for the appointment of a domestic custodian upon European hedge funds. The Group recommends that the provider of custody services to a European hedge fund should be a regulated provider of custody services, either domestically or in another Member State together with a minimum assets requirement.

AIMA endorses this Recommendation.

Recommendation 9

Custodians and prime brokers are established in highly regulated European jurisdictions and are subject to detailed rules governing the provision of custody services. The Group supports a requirement that custodians, whether appointed solely as custodians or as part of a prime brokerage mandate, should be obliged to act reasonably and take due care and skill in monitoring the sub-custodian.

In addition to the requirement that a custodian be regulated in a Member State, the Group would support the use of a minimum assets test by Member States. This would mean that a regulated firm that is appointed as a custodian to a European hedge fund would be subject to a minimum assets test and/or a requirement that the custodian or its ultimate parent hold a specified credit rating.

The Group recommends that Member State regulators and the Commission should seek to reduce regulatory discrepancies in this respect, especially in light of the intended harmonising effect of MiFID, with particular regard to the sections dealing with custody of client assets and the prohibitions against "gold-plating" the Level II provisions in domestic implementing legislation.

AIMA endorses this Recommendation.

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Recommendation 10

Re-hypothecation limits are a critical economic variable contributing to the cost and price of providing the prime brokerage service. Prime brokers are established in highly regulated Member States and are subject to detailed rules governing the provision of regulated services.

The Group recommends that neither Member States nor the Commission impose any regulatory restrictions upon re-hypothecation limits for European hedge funds and that such matters be regarded as commercial terms of business to be negotiated between the fund and the prime broker. Any right of re-hypothecation should, however, be transparent to investors through the medium of disclosure in the fund offering documents. The Group would support any requirement, either at Member State or Community level, that a right of re-hypothecation be coupled with an enforceable set-off clause in the brokerage documentation.

However, if a ceiling is considered necessary and supervisors insist on imposing some limit for investor protection reasons through further banking/prudential rules, then it is appropriate:

- to measure that limit by reference to the level of indebtedness rather than by reference to the NAV of the fund. A prime broker can determine on any day how much the fund owes it but it cannot easily track the NAV because calculating this requires more information than is available to each prime broker, especially as most large funds now have more than one prime broker;
- to couple limitation on re-hypothecation with close-out netting provisions which would enable the setting off of the prime broker's redelivery obligation against the fund's liabilities to the prime broker; and
- to ensure that each Member State recognises that a prime broker regulated in another Member State is entitled to provide prime brokerage services (for example, custody, clearing, stock and cash lending, and research) to hedge funds regulated within its territory.

AIMA endorses this Recommendation.

Recommendation 11

As regards asset valuation, considering the global nature of hedge fund operation and the active participation of most Member State regulators in the IOSCO Standing Committee n° 5, the Group does not wish to pre-empt the IOSCO report and make specific recommendations at this time. Nevertheless, the Group is hopeful that IOSCO will not recommend the need for direct regulation or legislation in respect of hedge fund valuation and that it will advocate a system of best practice that relies upon industry led codes of conduct and permits different levels of independence in relation to the valuation function coupled with transparency for investors through full disclosure, thus allowing hedge fund investors to take the level of independence of the valuation function as well as the methodology into account as part of the due-diligence prior to investing.

AIMA endorses this Recommendation.