Response to FSA's DP12/1: Implementation of the Alternative Investment Fund Managers Directive[1]

1. Introduction

The HFSB welcomes the opportunity to respond to the FSA's Discussion Paper DP12/1 on Implementation of the Alternative Investment Fund Managers Directive (AIFM-D).

The Hedge Fund Standards Board (HFSB) is the guardian of the Standards drawn up by international investors and hedge fund managers to create a framework of discipline for the hedge fund industry. The HFSB's mission is to promote the Standards through collaboration with managers, investors and the regulatory community.

The HFSB responded in the past to consultations on issues in relation to hedge fund regulation, including ESMA's draft technical advice on possible implementing measures of the AIFM-D, the European Commission Consultation on Hedge Funds, and IOSCO's consultation on Hedge Fund oversight.

The HFSB is pleased to continue to inform the regulatory process.

2. Overview

The following responses include examples as to how the Hedge Fund Standards deal with the specific issues raised in DP12/1. In this context, it is important to highlight that the Hedge Fund Standards are based on a comply or explain mechanism, providing flexibility for managers to deviate from the proposed practice as long as this is disclosed to investors.

[1] FSA DP12/1: http://www.fsa.gov.uk/static/FsaWeb/Shared/Documents/pubs/discussion/dp12-01.pdf

3. Consultation responses

The following sections provide responses to select questions raised in the FSA Discussion Paper.

Scope

Q1: What other criteria could be used to distinguish a JV from an AIF and, in particular, a JV where not all participants are involved in its day-to-day management?

Q2: How should we look to characterise the 'family relationship' between investors?

Q3: Are there other features of a family investment vehicle that might distinguish it from an AIF?

Q4:

(a) Which aspects of the Directive should we consider applying to small UK AIFMs?

(b) In particular, which aspects of the Directive should we consider applying given that a distinction may be drawn between types of AIF or AIFM?

General observations:

Many smaller firms registered with the FSA might not wish to be "deregulated". A two tier regime could also create confusion among investors. However, if the FSA chooses to introduce a proportionate two tier regime giving choice to smaller managers, then they should be able an opportunity to opt into the regulations applying to larger managers.

Operating requirements on AIFM's

Q5: What factors should be considered when assessing the fair treatment of consumers, especially where some investors in a fund have received preferential treatment?

Issues of fair treatment of investors can arise in many areas, including redemptions, valuations (e.g. conflicts between incoming and redeeming investors), governance, information access, etc. and it is difficult to come up with an all encompassing list.

To enable investors to assess potential conflicts, the HFSB has introduced several measures to enable investors to assess these conflicts, e.g.:

- Disclosure of total AUM in a given strategy (including managed accounts) [Standards 1.1; 2.4] (catering for conflicts between different funds and managed accounts)
- Disclosure of the fund directors' potential conflicts of interest (Standard 21)
- Disclosure of side letters which contain "material terms", and the nature of such side letters, e.g. where it relates to redemption rights (Standard 2.3).

Q6: Do you agree that fair treatment of retail consumers should equally apply to professional investors?

Fair treatment applies to all investors, but stricter requirements need to apply to retail investors. The HFSB deals with issues of fair treatment via disclosure to institutional investor, enabling proper investment analysis, due diligence while ensuring diversity and choice.

Q7: What organisational arrangements might raise particular issues for UK AIFMs? Do these requirements pose particular difficulties for private equity firms in the light of their distinct business model?

"Independence in conflict management" should take account of the organisational limitations of smaller firms to segregate the various functions and acknowledge the important role of boards in that respect.

Q8: What are the major challenges in the development of remuneration guidelines appropriate to the structure of AIFMs?

While ESMA/Commission have not commenced their work on detailed remuneration provisions, the HFSB would like to highlight the following aspects.

In our response to ESMA's draft technical advice to the Commission, the HFSB detailed the key differences between asset management and banking[2], and why it is important that the remuneration guidelines in asset management do not introduce a bias against risk taking. Therefore, a proportionate approach is crucial to appreciate this important distinction between banking and asset management.

Q9: What options could be considered for implementing the remuneration requirements of the Directive that would achieve fair and appropriate alignment with the existing Remuneration Code?

The Hedge Fund Standards include a provision requiring that a manager's staff remuneration should not set false incentives (Standard 17.a) (e.g. by linking the compensation of the valuation team directly to fund performance), but leaves the detailed approach to the manager.

Q10: What are the practical issues for potential AIFMs in establishing a remuneration committee?

Many smaller firms and owner managed investment managers may not have considerable staff (resources) outside the management of the firm to form a remuneration committee.

[2] Banking regulation needs to be prudential, i.e. introduce a bias against risk taking given the damaging externalities that arise when banks fail and most importantly protect the financial system

Q11: What criteria should be used to determine whether it is disproportionate to require an AIFM to have a separate compliance function? What criteria should be used to determine whether it is disproportionate for an AIFM to establish an audit function?

The Hedge Fund Standards highlight the need to separate certain activities (e.g. compliance, valuation) from the portfolio management function with individual reporting lines into the CEO, CIO, or similar. The HFSB acknowledges that smaller managers encounter certain constraints; however the Standards require disclosure to investors if certain segregations of functions are impractical (Standard 5.2). The HFSB has not set a specific size threshold or other criteria for this purpose, but relies on investor disclosure and the investor's expert assessment of individual circumstances.

Q13: In what circumstances would you be unable to meet the requirement to have functional and hierarchical separation of your risk management function and would need to rely on having appropriate safeguards?

The Hedge Fund Standards highlight separation of the risk monitoring function from portfolio management (Standard 11.2) but the HFSB also acknowledges that this might be impractical for smaller managers or start up firms, therefore requires disclosure to investors. The HFSB also acknowledges that notwithstanding the separation of the risk monitoring and the portfolio management functions, portfolio managers can typically provide input into the risk parameters to be applied to the portfolio.

Risk monitoring reports should be made to the person or body which is fully responsible for risk management, such as the manager's CIO, CEO or executive committee.

Q14: For what reasons might the use of a qualitative, not a quantitative, risk limit, be in the interests of AIF investors?

The HFSB highlighted the need to develop measures to identify portfolio risks (Standard 11), but also indicated the shortcomings of individual measures. Indeed, the financial crisis demonstrated that over-reliance on certain risk models and purely quantitative approaches (e.g. VAR techniques) can lead to situations where one may underestimate extreme financial events. Therefore, the HFSB introduced stress testing, scenario analyses and other approaches to generate a more holistic view on risks, which had also been incorporated in the AIFM-Directive. Overall, diversity in approaches to risk management contributes to financial stability and reduces the likelihood of herding behaviour (i.e. all investors applying the same type of risk measures and reacting similarly).

Q15: What constitutes a 'material change' to the maximum level of leverage set for an AIF may vary according to changes in the market. What factors should we take into account in determining what constitutes a material change?

As a matter of good practice, all changes to the maximum level of leverage should be disclosed to investors.

Q17: What are the particular challenges for your firm as a result of the delegation requirements? How will this affect existing operational structures?

Large integrated asset managers where portfolio management and other functions are sourced from around the world will face a significant administrative burden to notify regulators of all changes to internal management procedures, international staff involvement in the management of each individual fund etc. This will be particularly relevant where globally diversified investment portfolios are managed on behalf of clients.

Like in many other globalised industries and large international companies, (investment) value chains can be broken down into many process steps, drawing on offices, suppliers etc. from various countries. It would be damaging if the advance notification requirement would be applied in a manner to prevent firms from continually adjusting and optimising their approach, taking advantage of talent, skills and resources internationally.

Management requirements on AIFM

Q25: What are the most significant considerations that we should take into account when assessing the need to require AIFMs to have their valuation procedures and/or valuations verified by an external valuer or auditor?

The Hedge Fund Standards mention the use of an external party to evaluate the robustness and effectiveness of a manager's internal valuation approach (Standard 5). The Hedge Fund Standards do not provide any assessment criteria to determine whether an external verification or audit is needed. The criteria could be based on a risk based approach, taking into account the complexity/illiquid nature of the underlying assets and the proportion of the portfolio being in illiquid/hard to value assets.

Q28: Are there any particular challenges for your firm as a result of the liquidity requirements?

The HFSB would like to emphasise that the concepts and approaches set out in the liquidity management requirements of the AIFM-D have strong similarities with those included in the Hedge Fund Standards (Standard 12).

Q30: In what instances do you consider that neither the Gross nor Commitment methods of leverage calculation would provide a reasonable or approximate reflection of leverage within an AIF?

In its Final Report published in January 2008, the HFSB assessed the suitability of different types of leverage measures in the context of its Standards. One of the conclusions was that financial statement based ("e.g. gross") measures, which do not include hedges, may provide a misleading picture of "risk" and that generally risk based leverage measures (which relate a risk measure, such as e.g. VAR to the fund's ability to absorb losses) are more suitable, but require more assumptions and input parameters. Due to a wide spectrum of definitions on leverage and the differing suitability of the methods to employ investment instruments the HFSB does not prescribe any specific method, however the Standards (Standard 1.1 and 16.2) require disclosure of leverage by managers to investors as well as their definition of leverage. Indeed, as seen during the financial crisis, overreliance on individual (sometimes unsuitable) measures can be misleading and a more differentiated approach to risk measurement and management should be encouraged. Therefore, there should be more than one measure of leverage. Given the limitations of the various leverage measures, institutional investors increasingly focus on the underlying risk factors that can be used to calculate leverage (e.g. based on more detailed risk reporting, for example the "Opera" Risk aggregation framework) , and carry out their own assessments which will depend on the type of underlying portfolios.

Marketing

Q53: Should we create a distinct register or list for those non-EU AIFMs from whom we have received a notification of intention to market an AIF in the UK through national private placement?

The proposed register maintained by the FSA would be useful.