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A legal update from Dechert's Financial Services Group

French Securities Regulator Abrogates the "13 Criteria Rule"

Although certain French funds are not now and have not been prohibited from investing in unauthorized non-French hedge funds for a very long time[1], they have been permitted to make such investments, provided they complied at all times with certain criteria set by the French securities regulator (the *Autorité des marchés financiers* or "AMF"). The so-called "13 criteria rule", introduced in 2003, was adopted on the basis of "common sense" principles and aimed at ensuring enhanced protection to French funds of hedge funds.

By a decree (*arrêté*) released on March 31, 2008, the AMF abrogated the 13 criteria rule and released new rules in its place.

The 13 criteria rule notably included requirements regarding ownership of the units of the underlying fund, details of custodian arrangements, re-use of the units by the custodian or its agents, existence of rights and obligations arising from the underlying fund's own assets and liabilities. It also contained the principle of equal rights for all investors in the underlying fund and registration and supervision of the fund manager by a regulatory authority[2]. Finally, the 13 criteria rule required some form of disclosure to fund investors with respect to the underlying fund's net asset value and its availability on a monthly basis at minimum, quarterly disclosure of information about the management of the underlying fund at minimum and a prospectus explaining the investment and organisational rules governing the underlying fund.

The AMF began questioning its own rule some time ago. The "yes/no" nature of the criteria posed problems to asset managers (it led to legal uncertainty), and complaints from the industry prompted the regulator to concentrate on a verification approach more in line with its overall policy, which emphasises the responsibility of fund managers in conducting due diligence.

The failure of the Amaranth Multi-Strategy Funds in September 2006 also revealed that the 13 criteria rule had not prevented four French management companies from investing in the Amaranth Multi-Strategy Funds[3], although portfolio diversification rules greatly mitigated the impact of Amaranth's losses on the affected funds of funds.

In September 2007, a report by a working group led by a member of the board of the AMF, Mr. Philippe Adhémar[4], emphasized that the 13 criteria rule ought to be abrogated and replaced by a new regulatory approach. This approach would be based on giving management companies responsibility for due diligence, i.e., increasing *ex post facto* controls and making professionals more accountable instead of conducting systematic *ex ante* reviews which did not prove satisfactory in terms of protection.

In the context of the Amaranth failure, the Adhémar Report commented on some of the lessons for the French finance industry: the fact that Amaranth losses stemmed from an uncontrolled liquidity risk, which although never easy to measure in practice is one of the main

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1 It is the marketing in France of those unauthorized hedge funds which is however very limited.

2 This requirement caused the AMF to recognize a grandfathered clause at the end of 2006, in light of the June 23, 2006, ruling by the U.S. Court of Appeals of the District of Columbia Circuit, for funds whose managers had deregistered from the SEC.

3 Around 15 French funds were reported to be affected by the failure of the Amaranth Multi-Strategy Funds, five of which had invested directly in the fund.

4 Report of the working group chaired by Philippe Adhémar on the assessment of the French regulatory framework for funds of hedge funds and on possible areas of improvement of September 18, 2007 (the "Adhémar Report").

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risks that a manager should identify and assess, and that the manager should exercise greater vigilance if the legal documentation gives full discretion to the hedge fund manager on investment strategy.

In a move to reduce the risks identified by the AMF in general and the Adhémar Report in particular and to achieve its enhanced due diligence objectives, the AMF abrogated the 13 criteria rule and released its new rules. Revised Article 411-34 of the AMF's General Regulation, which is in line with the recommendations of the Adhémar Report, now limits the requirements to a set of four general principles concerning crucial aspects of the legal regime, the functioning and the organization of underlying hedge funds:

- the rights attached to the shares or units of the fund of funds are enforceable on the assets of the underlying fund;
- the assets of the underlying fund are held separately from those of its custodian and other agents;
- the underlying fund must regularly disclose "adequate" information, its shares or units must be valued "appropriately" by the underlying fund at least once a month and there must be a legally binding requirement for the financial statements to be audited at least annually; and
- the fund's home country is not on the blacklist of countries issued by the Financial Action Task Force.

The revised regulations maintain the risk spreading rules (the so-called "5/10/40 ratio") according to which no one investment by regular fund of funds can represent more than 5% of the portfolio of that fund, with the exception of four investments, which can represent 10% individually and 40% collectively. For a fund that is fully exposed to hedge funds, the minimum number of investments is therefore 16 (i.e., four with a weighting of 10% and 12 with a weighting of 5%). In addition, it is worth mentioning that the French rules also provide maximum investment ratios for unauthorized funds[5], which have a direct impact on the possibility for French funds to invest in such unauthorized funds.

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This update was authored by Joseph J. Smallhoover and Alexandre Marion.

[5] The extent of such latitude varies depending on the funds involved. While a regular fund of funds can invest 10% of the fund's assets in hedge funds, this maximum investment can go up to 50% for the so-called ARIA funds (which are the French regulated hedge funds)—40% of which had to comply with the 13 criteria rule (which now must comply with the revised rule) and even 100% for funds of funds ARIA—10% of which had to comply with the 13 criteria rule (which now must comply with the revised rule).

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