

Appendix C

European Commission - Recommendations of the “Report from the Alternative Investment Expert Group” (“The Group”) Managing, Servicing, and Marketing Hedge Funds in Europe

July 2006

Subject matter	Recommendations of the expert Group
<p>Recommendation 9</p> <p>Custodians and Prime Brokers</p>	<p>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 skill in monitoring the sub-custodian.</p> <p>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.</p> <p>The Group recommends that Members State regulators and the Commission should seek to reduce regulatory discrepancies in this respect, especially in light of the intended harmonizing effect of MiFID, with particular regard to the sections dealing with custody of client assets and the prohibitions against “gold-planting” the Level II provisions in domestic implementing legislation.</p>
<p>Commentary by the Expert Group</p>	<p>The Expert Group report is of the view that the custodian should not bear full liability for asset restitution and any sub-custodian performance and that a simple liability standard should be applied with regard to the selection of ongoing monitoring of any sub-custodial network. This poses difficulties for any operator in the DIFC who has a general duty to safeguard the assets of the fund pursuant to in CIR rule 6.3.1(1). They argue that additional layers of control over prime broker activity may act against the interests of investors by significantly reducing the range of markets and instruments that the Hedge fund can invest in. They conclude by stating that if there is a need for greater investor protection then the focus should be on the managers/operators conduct.</p>

<p>Recommendation 10</p> <p>Rehypothecation</p>	<p>Re-hypothecation limits are a critical economic variable contributing to the cost and price of providing the prime brokerage service. Prime brokers established in highly regulated Member States are subject to detailed rules governing the provision of regulated services.</p> <p>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 prime brokerage documentation.</p> <p>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:</p> <ul style="list-style-type: none">• To measure that limit by reference to the level of indebtedness rather than by reference to the net asset value of the Fund. A prime broker can determine on any day how much the fund owes it but it cannot easily track the net asset value 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.
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Commentary by the Expert Group	The Expert Group is of the opinion that this use of assets by a prime broker reduces costs and increases returns. The risk is that when there is an event of insolvency of a hedge fund the obligation of that fund form part of set off calculation against the amount the fund owes the prime broker. Where the amount of assets re-hypothecated is in excess of the amount the hedge fund owes then the fund is an unsecured creditor for the excess following the operation of the set off. Restrictions on re-hypothecation such as 100% of NAV increases financing costs and make such jurisdictions less attractive to hedge funds.
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