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FEPS Answer to Commissioner McCreevy consultation on Hedge Funds

When the G-20 is calling to “*ensure that all financial market products and participants are regulated or subject to oversight, as appropriate to their circumstances*”, one has to wonder why such regulation would be needed. Without doubt, financial stability is essential for a smooth growth in wealth creation. Financial markets are a tool, and not an end in themselves, “*supposed to perform certain vital functions which enable the real economy to be more productive*”¹.

However, when calling for more transparency, accountability, simplicity and disclosure, as often suggested, one has to wonder in what sense such information can be a source of financial stability. In fact, economic theory is divided on this point. Regulation can have a double meaning referring to different visions of the economic system. Therefore the question of regulation has to be analysed with regard to the economic debates which have been running for nearly 300 years now. Actually the question underlying the different types of regulation can be summarised in the

¹ See Stiglitz (2007), “*Social Democratic Principles Towards a New Financial Architecture*”, http://www.fepe-europe.eu/fileadmin/downloads/081013_FEPS_Stiglitz.pdf



following way: “Are variations in the relative price system the only source of information necessary in order to achieve financial stability?”

From the answer to this question one will be able to differentiate the different kinds of regulation principles needed and the institutions in charge of such an oversight. It will be possible to notice that some regulatory principles proposed could damage the European integration process whereas it seems that the present financial turmoil would call for a more integrated, global European regulation.

(1) Are the above considerations sufficient to distinguish hedge funds from other actors in financial markets (especially other leveraged institutions or funds)? If not, what other/additional elements should be taken into account? Do their distinct features justify a targeted assessment of their activities?

It seems, with regard with the above considerations, suggesting a strong link, and moreover a link of subordination of financial markets to the real economy, that all financial institutions should be considered as potentially regulated. Therefore all collective investment vehicles (CIVs) except for specific exemptions should be considered in the regulatory framework designed by the Commission. This proposition is supported, among others, by the Group of Thirty².

However, all financial institutions are not subject to the same opacity and a relative degree in the priorities should be considered.

The difficulty to give a clear definition of hedge funds due to the multiplicity of investment strategies doesn't prevent from identifying some behaviour, some activities which are problematic in themselves and which are often the "touch" of Hedge funds.

² See Group of 30 (2008), “*Financial Reform: A Framework for Financial Stability*”, <http://www.group30.org/pubs/recommendations.pdf>



(2) Given the international dimension of hedge fund activity, will a purely European response be effective?

The more the E.U. can do, the better it will be for the global regulation of financial markets.

Nonetheless, it seems that this question is *ad hoc*. *Ad hoc* on the basis that it serves an already designed plan of action. If E.U. cannot ensure an effective regulation all over the world, should one not wait for a global strategy which will come later?

In any case, this question is out of date given the strong impulse towards the implementation of regulation principles in the United States of America. To delay the financial reforms needed for financial stability would *de facto* place Europe in a follower position, and would limit its potential in suggesting regulatory principles.

Nevertheless, to ensure an effective and competitive single financial market in Europe, the European Commission should establish an EU framework for the registration and authorisation of Hedge Funds and entities that control the investment of Hedge Funds.

This can be done by harmonising European Hedge funds in order to create a unitary category of onshore funds with a common minimum investment threshold. To tend towards the elimination of off-shore Hedge funds, a first step would surely be to develop an onshore regime able to compete with offshore funds. Thus, such EU regulated products would be offered in a first row as a complement to offshore funds. The features of such onshore products would reduce the size of the offshore market compared to the onshore one.

(3) Does recent experience require a reassessment of the systemic relevance of Hedge funds?

The question already stipulates a positive answer. Yes, due to the size of their assets, the number and exposure of their counterparts, the level of leverage and the pro-cyclicality of their activities, their systemic relevance has to be reassessed, in light of the financial crisis.



Although they are more than likely not at the source of the crisis, Hedge funds have significantly contributed to its propagation through a large dissemination of risk in society. For instance, acquisition of a substantial portion of CDOs has led to an increased indirect exposure of institutional investors to such products.

And furthermore Hedge funds are acting as de facto non regulated banks in using short term financing for investment in non liquid assets.

(4) Is the 'indirect regulation' of hedge fund leverage through prudential requirements on prime brokers still sufficient to insulate the banking system from the risks of Hedge fund failure? Do we need alternative approaches?

If there is a potential systemic risk danger, by definition, the question should not be limited to the regulation of Hedge funds only but also to the regulation of their “eco-environment”.

It could be argued that the indirect regulation was useful to insulate the banking system from Hedge funds failure but to what extent the recent failure of banks was speeded up by the pro-cyclical behaviours of Hedge funds needs to be clearly assessed. In addition, this indirect regulation through prime brokers does not insulate other institutional investors such as pension funds, public institutions or insurance companies which are not subject to the same type of prudential rules. And, it does not prevent from the consequences of Hedge funds failure on market prices (see Amaranth case). Long-term market disruption should not be the only criteria to assess whether the existing indirect regulation is sufficient.

Given also the increasing complex relationships of financial actors, and the fact that they are mutually dependant at a very deep level, it seems that “*reducing the systemic relevance of Hedge funds*” implies both direct and indirect regulation proposals. Therefore not only prime brokers should be regulated, but also, Management companies, Hedge funds, Administrators and Distributors.



Nonetheless, one should not limit the regulatory principles to prudential requirements without specifying them. They should not be limited to the disclosure of information but must also cover capital requirements.

However, even as such, regulatory measures would not be sufficient. If one sees the present instable character of the economy as a consequence of a lack of information, as a consequence of past biased investment decisions, based on biased price variations, surely it seems enough to ask for more information concerning general investment strategy, leverage/debt exposure, fees, source and amount of funds raised, performances, risk management and method of evaluation. Surely also, it would seem enough to let the financial institutions agree on the amount of capital requirements given the risks attached to their investments.

Nonetheless, this will in no case prevent any conflicts of interest and collusions. The question at stake is much more about the possible level of systemic risk endorsed by financial market participants. Collusions of financial actors, between rating agencies and Hedge funds for example, should be revealed by their registrations and condemned. Therefore not only participants on financial markets should be regulated but also the financial products exchanged between them. They should be considered and analysed with a special emphasis on their utility for the real economic productive process. Investments should always be carried out with respect to their purpose for the real economy's smooth productive process of wealth creation. In this respect, an agency in charge of analysing the potential risk associated for financial products should be implemented, as it seems there exists strong links between the proliferation of new financial products and the (non-)independence of financial actors.

Therefore, the question is not only to disclose the information but also to know what could be done with this information. Surely a pro-market answer would consider the lack of transparency on financial markets was the cause of the present turmoil and that a more stable accumulation path should be achieved by regulatory measures aiming at revealing the information.

A more reasonable answer would consider that even if the most transparent information is dispatched on the financial markets, variations of relative prices are not always stabilising. In other words, the sum is not the addition of the parties, neither does the macro-economic



orientation of the economic system come directly from the intentions of the economic actors, while being the consequence. In this respect, to regulate the financial system, and Hedge funds more specifically, it will require some interdictions concerning the direction, the products and the amount traded and invested, with regard to their “pro” or “counter-cyclical” effects and their role in the perpetuation of a smooth and stable wealth creation process.

If it is necessary to analyse the interactions of financial activities with regard to their implications in the real economy, one has to state that the more Europe will act as one economic and political actor, taking into account the global regional and national financial economic interdependencies, the more regulation principles will be used in a coherent and inclusive way. On the other side, sadly enough, as usual, the European answer of the present crisis could be delegated to national member states, defending the market as a tool for a true European political integration process.

In addition, given the increasing facility of financial actors to circumvent capital requirements, the institution in charge of the implementation and respect of the regulations principles has to be independent of financial actors. In other words, self-regulation has to be abandoned³ and Basel II requirements should be reformed and extended to all financial actors and with higher ratios for capital requirements.

The feasibility of indirect regulation via banks is not adequate and cannot be taken for granted. Banks have no incentives to be the regulators’ scrutinisers of hedge funds. Banks themselves are acquiring or setting up Hedge funds. In addition prime brokerage for hedge funds is sold with a whole bundle of services (clearing, settlement of transactions, custody of assets, research, legal advices and the like). This is a very profitable business.

(5) Do prudential authorities have the tools to monitor effectively exposures of the core financial system to hedge funds, or the contribution of hedge funds to asset price movements? If not, what types of information about hedge funds do prudential authorities need and how can it be provided?

³ See Recommendation 6b of the Group of 30, <http://www.group30.org/pubs/recommendations.pdf>



Considering financial markets as a sector of production in itself prevented to analyse the role of the financial system for a stable economic growth path and given also the increasing complexity of the products traded and of the financial actor's network, it does not seem that "*prudential authorities have the tools to monitor effectively the core financial system to Hedge funds*".

It would be therefore crucial to implement a global registration of the different financial actors according both, given the fact that there does not exist any non undisputed method for an exhaustive census of financial actors, to the European location of the Hedge funds or financial institutions and to the place of residency if their investors. It should be possible to implement this database on a European level without difficulty.

However, this list cannot be an aggregation of the member states lists. It has to be one list. Once registered in a country, the database of reference should be the European one. This technique would allow registering a maximum of financial actors and would make the implementation of European regulatory principles easier. All the relevant categories of the database should be public.

One could also extend this list by requiring any financial institution desiring to invest in the European market to be registered. Surely, this would not diminish the attractiveness of the European Union given the necessity for any financial actors to diversify their portfolios. On the contrary, one could think that investors could be more confident if they know a legal structure of supervision is designed in order to prevent the occurrence of any bubble. This would surely imply that the financial institutions should also be considered as subject to the regulation principles.

(6) Has the recent reduction in hedge fund trading (due to reduced assets and leverage, and short-selling restrictions), affected the efficiency of financial markets? Has it led to better/worse price formation and trading conditions?

The recent reduction in Hedge funds trading has nothing to do with the efficiency of the financial markets. A market is efficient when the quantities sold and bought on markets respect agents' desires and constraints in a competitive environment. The question should therefore be directed



towards the possible consequences of the recent reduction in Hedge funds trading on the stability of the production process.

The fact that financial markets' functioning and price formation have been affected by the reduction of hedge fund trading only show how important these market players are and how necessary it is not to underestimate their impact, for good or for worse.

The problem is consequently not to restrict any financial activity *per se* but to analyse to what extent these actions can be a source of growth, given the economic environment or destabilising.

(7) Are there situations where short-selling can lead to distorted price signals and where restrictions on short-selling might be warranted?

Short-selling activities are normal economic practices. However, they should be limited following the considerations below. When short selling activities are carried out for speculative purposes, they should be stopped. In addition, when short selling could cause instability on the financial markets, they should not be allowed.

Even if it is only a limited part of Hedge funds that is actually practicing short selling, those who do are often accused of being trend-setters and causing price depreciation independent of the economic performances in the real economy. This was for instance the case during the currency crisis of 1992, where some believed that the short selling strategies of the Soros-led Quantum Hedge fund were the sole cause of the devaluation of the British Pound.

In the light of the current size of assets under management, there can be little doubt that some hedge funds – alone or through concerted action – can influence prices independent of fundamentals, thereby causing instability. Such was the case for Porsche and Volkswagen and the consequences even for other companies, like the Merckle Group in Germany.



(8) Are there circumstances in which short-selling can threaten the integrity or stability of financial markets? In combating these practices, does it make sense to tighten controls on hedge funds, in particular, as opposed to general tightening of market abuse disciplines?

The practice of short-selling can be destructive, as it has been clearly demonstrated by the current situation. Therefore controls are needed, not only on hedge funds but on all market players.

Furthermore “naked” short selling appears dangerous as it may lead to short selling of more securities of a company than are listed. This may lead to serious distortions in price signals and threaten the good functioning of financial markets, and therefore the stability of the production process of the real economy.

(9) How should the internal processes of hedge funds be improved, particularly with respect to risk management? How should an appropriate regulatory initiative be designed to complement and reinforce industry codes to address risk management and administration?

Hedge funds and hedge fund management companies should be subject to appropriate rules regarding bonuses and compensation, in order to limit pro-cyclical conduct resulting from a system providing for high bonuses in the event risky strategies succeeded and no reciprocal downside occurred in the event of failure. These rules would be applicable when investors are EU pension funds, commercial banks, collective investment schemes or insurance companies.

It seems quite paradoxical that the value of any financial institution is established in a forward-looking manner when the remuneration of managers and administrators depend on the past results of the company. Presently, this remark is particularly accurate when considering managers receiving huge bonuses when all the economic system is collapsing.

One can see here the fantastic degenerated internal process of Hedge funds. In periods of crisis, nothing induces administrators to act as true entrepreneurs. In this respect, remunerations based also on forward-looking incentives should also be considered. On the other side, methods of valuation of assets, and therefore financial institutions, should also be considered with reference



to their past results. These are counter-cyclical incentives which could prevent the occurrence of bubbles and the worsening of any financial bubble burst. There should be in all circumstances an independent evaluation of the risk management and also an independent custodian service.

Furthermore an appropriate level of qualification to be required from hedge fund managers would be a way to guarantee a better capacity to understand risk and manage it. This would be part of the necessary fulfilments when registering.

(10) Do investors receive sufficient information from hedge funds on a pre-contractual and ongoing basis to make sound investment decisions? If not, where do the deficiencies lie? What regulatory response if any is needed to complement industry codes to make a significant contribution to the transparency of hedge fund activities to their investors?

The purpose of any regulatory reform is not the implementation of an industry code of conduct. We try to take for granted that risk managers and administrators are honest, trying to obtain the highest return from any investment decision, given their legal environment. If it seems they are not following a specific code of conduct, they are just following their code of conduct i.e. to obtain the highest yields. In this respect the legal system surrounding financial institutions and their activities has to be modified. As suggested above they should be prepared to disclose information on their investment strategies, their exposure to risks, agencies in charge of such evaluations, sources of their funds, their debt exposures, clear definitions of the products traded. In addition, financial institutions should consider that an external and independent supervisor could be in a position to forbid such positions and activities before financial actors can even analyse the micro-economic risks associated to some investments.

Therefore not only financial markets participants and products should be “transparent” but the information could be used to prevent the launching of rentable but destabilising investments.

Nevertheless and in order to promote a well-functioning single European market it should be ensured that the management firms of Hedge funds disclose the following information to obtain authorization:

- The name and address of funds they control,
- The identity of managers and, if any, of external investment advisers,
- A detailed and comprehensive track record of managers and, if any, of external investment advisers,
- Corporate earnings and bonuses,
- Remuneration of directors, senior executives and other staff with investment responsibilities, and, if any, of external advisers, and
- Relationships with prime brokers.

This information should be set out in a uniform format in order to facilitate the proposal for a database. Furthermore relevant information should be disclosed to the investors in the sense to enlighten:

- The general investment strategy and any immediate information on changes thereto,
- Risk profile,
- The Leverage/debt exposure,
- The Overall fees as well as breakdown of fees (including any stock options awarded to employees),
- The Source and amount of funds raised,
- The Past performance,
- The Risk-management system and portfolio valuation methods,
- The Information on the administrator of the fund, and
- The Share of the fund contributed by the management company and its staff.

(11) In light of recent developments, do you consider it a positive development to facilitate the access of retail investors, subject to appropriate controls, to hedge fund exposures?

No. The risk associated to the U.S. housing market having been largely dissipated to all financial actors through an unconscious dissemination of risk in society. This created therefore a huge systemic risk in the economic activity. It seems unwise to consider facilitating the access of retail investors to Hedge funds exposures. Ordinary people who could be retail investors are already indirectly affected for instance if they are dependent on capital based pension systems.

Moreover, allowing Hedge fund products to be distributed towards retailers would raise specific investor protection concerns, such as inadequate disclosure, the risk of mis-buying and mis-selling, the lack of sufficient diversification and disproportionate management costs etc. Some of



these concerns can be addressed by only allowing certain variants of hedge funds to be commercialised such as funds with capital protection.

The added value that Hedge funds bring to retail consumers is more than questionable and it would seem is reasonable to argue for a solid regulation to avoid the potential damage of the access of retail investors.

This contribution has been elaborated in the frame of the FEPS expert group on Hedge funds. Any further information can be obtained through the Secretary General of FEPS, Ernst STETTER (ernst.stetter@feps-europe.eu).