

To: markt-consult-hedge-funds@ec.europa.eu

Dear Sirs,

here are my answers to the consultation on Hedge Funds:

1. SCOPING THE ISSUES

(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?

Most significant characteristic of hedge funds is their systematic and extensive use of regulatory unlimited leverage and short selling. The use of leverage multiplies their exposures to systemic important counterparty institutions (i.e. large prime brokers) and therefore causes the relevance with regard to systemic risk and in the end with regard to investor protection. This justifies a targeted assessment of their activities backed by the fact that information on strategies and activities of hedge funds to analyze their systemic risk role are fragmentary.

For the distinction of hedge funds and private equity investments should be taken into consideration that private equity investments are characterized as long-term investments. In contrast hedge funds are collective investment vehicles giving investors the right for short-term redemption.

Additional distinguishing feature is that hedge funds are subject to no or extremely limited investment restrictions in comparison with other investment funds, e.g. diversification rules in most cases are not applicable. Furthermore due to their active trading strategies hedge funds make up a significant share of the trading volume in several market sectors.

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

National measures will obviously fail to raise standards for the global hedge funds industry sector. A European Single Market for hedge funds would abolish regulatory fragmentation and would strengthen Europe's position in negotiations for international standards. A European initiative would be an essential step to reach an international consent on the framework for hedge funds. A global response is urgently needed in order to avoid regulatory arbitrage. The current G 20 process offers the opportunity for a coordinated global approach to this issue.

2. SYSTEMIC RISKS

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

It is generally acknowledged that hedge funds activities are an integral part of the financial market due to their positive and stabilising aspects, e.g. improvement of market liquidity and market efficiency by arbitraging away price differences. Hedge funds furthermore have become key allocators of capital with a willingness to take risks. However, these stabilising effects of hedge funds activities were reduced throughout the recent crisis.

According to the Financial Stability Reviews of the European Central Bank in 2008 hedge funds were forced to rapid and significant deleveraging as prime brokers tightened margin requirements and terms of lending. In the following hedge funds were forced to sell assets, depressing securities prices in some of the most liquid markets. Because of the rapidity with that hedge funds tend to turn over their portfolios their trading presence in some markets is disproportionately large relative to their assets under management. That means financial stress in this sector may quickly lead into vanishing market liquidity and reducing market stability. Furthermore due to their weak investment performance results many hedge funds were confronted with substantial investor redemptions. Further sizeable position unwindings by hedge funds caused by high investor redemptions and more frequent cases of hedge fund liquidation may pose a challenge to the financial market.

To sum up, recent events have provided further information on the effects of hedge fund failure, particularly in times of general market distress. Hedge fund actions induce indirect effects, e.g. the temporary distortions in market liquidity and market prices that cause distress to other market participants. Hedge funds' activities have presented indirect risk to core financial institutions and the broader financial system stemming from sudden and large scale liquidation of hedge funds positions, the influence on market price dynamics and market liquidity as well as its contribution to broader market distress.

Foregoing analysis requires a further reassessment of systemic relevance of hedge funds and the initiative to contain potential stability risk at least on European level.

(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?

An appropriate prudential regulatory treatment of hedge funds has to take into consideration two different aspects: the regulation has to address on the one hand investor protection and on the other hand potential systemic risk of hedge funds in the financial market. The level of investor protection standards depends on the group of investors to whom hedge funds may be distributed (general public or sophisticated investors).

Taking these aspects into account a direct regulatory approach to hedge funds on EU level should be seriously discussed and reconsidered.¹ The existing best practice standards of the hedge funds industry² could be used as a prudential basis for this discussion. The current efforts to develop globally unified best practice standards are appreciated and should be taken into account. However, best practice standards on a stand-alone basis seem to be not sufficient due to the unspecific nature of these standards and the weak process of enforcement and compliance assessment.

On hedge fund regulation, following areas should be considered:

1. First of all, for the purpose of identification of hedge funds, a registration rule for hedge funds should be imposed that requires hedge funds (exceeding a certain minimum size) to register with an appropriate regulatory authority. Presently, authorities have only a rough understanding of hedge funds' relevance for financial markets as they lack information and tools for an ongoing assessment of broad developments in the hedge funds sector. With the registration of hedge funds authorities would receive a better insight into the hedge funds industry and its potential for systemic risks.
2. Transparency and disclosure standards for hedge funds with regard to investors, counterparties (e.g. prime brokers) and regulatory authorities should be

improved and harmonized. Hedge funds should be required to periodic regulatory reports of appropriate information on size, investment style, exposures, leverage and performance. This would facilitate authorities to evaluate and monitor the systemic risk role of hedge funds. The level of transparency with regard to investors depends on the type of investors (retail or sophisticated investor). By improving the transparency of hedge funds the hedge fund business model must not be impaired and the legitimate interests of hedge funds not to reveal their proprietary trading strategies shall be taken into account to an appropriate extent.

3. Hedge funds should be obliged to install an adequate risk management system. For further details see below the answer to question no. 9.
4. According to the UCITS Directive the assets of a UCITS fund must be entrusted to a depositary for safe-keeping and the depositary must act in its function as depositary solely in the interest of the investors. The concept of an independent depositary should be used as model for the regulation of hedge funds.
5. Another aspect is the valuation practices of hedge funds. The regulated investment funds industry in Europe has to observe valuation principles set out in the Eligible Assets Directive 2007/16/EC. The UCITS Directive states that specific valuation rules must be laid down in the law, in the fund rules or in the investment company's instruments of incorporation. Similar regulation could be laid down for hedge funds.

The aforementioned direct approach should establish an EU Single Market for hedge funds. However, measures solely on the European level would have an adverse effect as they cause incentives to relocate hedge funds outside from Europe into offshore domiciles. Therefore a global response to the international dimension of this issue is needed to avoid regulatory arbitrage. In case a direct global regulation is technically too demanding and would not be accepted in the global process at least an improvement of indirect regulation via prime brokers should be implemented globally. Accompanying this indirect approach, hedge funds should be obliged to explain on their compliance with the best practice standards of the hedge funds industry ("comply or explain"). Following this approach regulated institutional investors should only be allowed to invest in hedge funds that comply with the best practice standards.

(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?

From our point of view prudential authorities are not sufficiently equipped to monitor effectively exposures of the core financial system to hedge funds, or the contribution of hedge funds to asset price movements. Hence, we recommend a (global) registration rule for hedge funds and the improvement of transparency and disclosure standards inter alia towards authorities (for further details see above the answer to question no. 4)

The following procedure should here be taken into account: According to the Regulation (EC) No 958/2007 of the European Central Bank (ECB) of 27 July 2007 concerning statistics on the assets and liabilities of investment funds (ECB/2007/8), all investment funds including hedge funds in the European Union have to notify important information to the National Central Banks (NCB) as of December 2008. This information includes assets under management, stock data of assets and liabilities and changes in these stock data due to transactions, each on a fund-by-fund and security-by-security basis. While the Regulation requires a quarterly notification, it provides that the NCBs may choose to collect the data on a monthly basis, which is the intention of the German NCB (Bundesbank).

3. MARKET EFFICIENCY AND INTEGRITY

(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?

There is no empirical evidence available to German authorities regarding the effects of the recent reduction in hedge fund trading on the efficiency of financial markets, price formation and trading conditions.

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

In general, short-selling transactions have the potential to increase a downward pressure on market prices leading to excessive price movements. Especially if the market prices of shares of companies in the financial sector such as credit institutions, insurance firms or stock exchange operators are affected this could jeopardise the stability of the financial system and thus lead to serious disadvantages for the financial market. Furthermore, short transactions also carry the risk of exacerbating liquidity shortages by putting pressure on share prices, thus making it more difficult for the companies to raise capital. In addition, short-selling transactions may also be used in the course of market manipulative behaviour (e.g. short and distort: short a share first, then spread rumours without disclosing the short position).

Against the background of an extremely unusual volatility in the financial market, particularly in the aftermath of the collapse of several internationally significant banks the German supervisory authority banned certain types of short selling of the shares of 11 financial sector companies in September 2008 and prolonged the restriction for another three months at the end of December 2008.

(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?

See answer to question no. 7 with regard to the stability of financial markets.

Since short selling is not only conducted by hedge funds but also by other market participants and institutional investors it is doubtful whether only hedge fund related controls would be appropriate. We expect that such rules would result in regulatory arbitrage. Therefore, it would be more appropriate in our view to discuss the approach to short selling not only in respect to hedge funds but in a wider frame (for example as done by the IOSCO Task Force on Short Selling). The same applies to the issue of market abuse.

4. MANAGEMENT OF MICRO-PRUDENTIAL RISKS

(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 should be obliged to install an adequate risk management system by way of direct regulation (see above the answer to question no. 4).

The hedge funds' industry best practice standards contain a broad range of risk management principles and include the main aspects that should be considered regarding this issue.

In Germany the supervisory authority demands high risk management standards for hedge funds, which has in our view proven to be successful:

The German Investment Act requires an appropriate risk management for all investment funds including hedge funds, which in particular guarantees that the risk attached to the investment positions and their relevant effect on the overall risk profile of the investment asset pool can be monitored and measured at any time. For hedge funds a risk management system has to be established that is able to detect, assess and control all the risks associated with the specific fund on an ongoing basis. All relevant risk factors such as market risk, credit risk, liquidity risk, and other (e.g. operational risk, reputation risk) has to be taken into account. The risk management techniques must be sufficiently advanced and state-of-the-art; an appropriate limit system must be established and documented for each hedge fund. The German supervisory authority requires functional separation, i.e. responsibility for the detection and assessment of risks, the development and maintenance of methods for risk monitoring must be assigned to a person or department that is separated from the portfolio management. For the assessment of market risk an accepted value at risk model is requested. Based upon this risk assessment the supervisory authority requires for hedge funds appropriate stress tests, in particular, for risks that are not sufficiently represented in the applied risk model.

Prior to licensing a hedge fund, the supervisory authority assesses the adequacy of the risk management by means of an on-site inspection. The suitability of the risk management system is furthermore annually monitored by external auditors.

5. TRANSPARENCY TOWARDS INVESTORS AND INVESTOR PROTECTION

(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?

Transparency and disclosure standards for hedge funds with regard to investors should be improved and harmonized by way of direct regulation (see above the answer to question no. 4).

The level of transparency for hedge funds with regard to investors is first depending on the type of investor (retail or sophisticated investor). On the other hand it should be taken into account to an appropriate extent the legitimate interest of hedge funds not to reveal their proprietary trading strategies.

The basic requirement is that disclosure standards should cover all essential aspects in an aggregate form so that investors may assess the relevant hedge fund's financial situation and risk profile. This includes adequate risk-related information such as the exposure to market risks, based on Value-at-Risk figures and appropriate stress tests, on credit and liquidity risks and to risk concentrations.

Another matter of concern is the existence of side letters, leading to information asymmetries among the group of investors. Equal treatment of all investors or at least full disclosure of side letters should prevail as basic principles.

The German regulatory framework on transparency provides investors with sufficient information to make sound investment decisions in hedge funds. Prior to the subscription of units by the investor, a full prospectus containing all information as prescribed by the German Investment Act must be handed over to the investor. This prospectus must also enclose the contractual terms approved by the German supervisory authority. In case of fund of hedge funds, the prospectus must include additional information regarding the target funds (e.g. their strategies). It must also contain a warning note that the investor may suffer a loss up to the total amount of the investment. Funds of hedge funds are also obliged to publish annual and interim reports, which have to be filed with the German supervisory authority immediately upon publication. Although, issuer and redemption prices have to be published at least once per calendar quarter single-hedge funds are not required to publish annual and interim reports, since they are not allowed to be publicly distributed in Germany.

(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?

The recent developments do not have an impact on the question whether retail investors should have access to hedge funds. The access of retail investments in hedge funds should depend on the regulatory standards for investor protection.

Kind Regards

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