



TRADE UNION ADVISORY COMMITTEE  
TO THE ORGANISATION FOR ECONOMIC  
COOPERATION AND DEVELOPMENT  
COMMISSION SYNDICALE CONSULTATIVE  
AUPRÈS DE L'ORGANISATION DE COOPÉRATION  
ET DE DÉVELOPPEMENT ÉCONOMIQUES

## European Commission (DG Internal Market) Public Consultation on Hedge Funds

### Submission by the TUAC DRAFT

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In the context of the current global economic crisis the TUAC welcomes the initiative by the European Commission (DG Internal Market) to conduct a public consultation on hedge funds. As representatives of workers in the real economy, trade unions across Europe and beyond have on numerous occasions expressed their concern about the impact of the phenomenal growth of hedge funds over the past decade on the sustainability of the real economy and companies and on working families (see Annex 1). TUAC therefore welcomes this opportunity to submit its comments on the EC DG Internal Market Working Document (hereafter the “EC paper”).

#### ***Defining the overall framework***

Before addressing the five areas on which further information is sought, the TUAC would first like to emphasise the need to more clearly define the framework for the Commission’s future work on hedge funds than is currently the case in the paper, both with regard to the G20 process and to other EU bodies.

According to the EC paper, the consultation is part of a “comprehensive review of the regulatory and supervisory framework” linked to the Action Plan agreed at the G20 Crisis Summit in Washington in November 2008. The paper also makes reference to a European Parliament Resolution (September 2008) on hedge funds and private equity.

Concerning the G20, the paper quotes two separate sections of the Action Plan, which have different meanings with regard to hedge funds. On the one hand, the paper states that the consultation is in line with the G20’s commitment to “Enhancing sound regulation” and within that to carry out a “review of the scope of financial regulation” with a special emphasis on institutions and pools of capital “that are currently unregulated”. On the other hand, it

quotes a separate section of the G20 Statement that deals with transparency and which requests the G20 Finance Ministers to “assess the adequacy” of existing hedge fund-related voluntary codes and “best practices”.

In our view, the work of the Commission on hedge funds should be embedded in the G20’s overarching objective of strengthening regulatory regimes in the light of the global financial crisis. Such an approach would also be consistent with the European Parliament Resolution (September 2008).

By contrast, it is TUAC’s view that the Commission should not carry out work on self-declared, voluntary transparency initiatives. The latter are inadequate and are in fact contradictory to core business model of hedge funds as we argue below.

### ***Scoping the Issues***

#### *1) The Scope*

The EC paper proposes a number of criteria for defining a hedge fund, which in our view are too broad and incomplete. ‘Alpha’ investment returns, leverage and regulatory exemptions are not specific to the hedge funds but are generic to all alternative assets, not least the sister industry of hedge funds: the private equity groups.

In our view, key investment characteristics should include short-term trading behaviour and a remuneration structure for managers based on “outperforming” the market: when hedge fund managers lose money, they have huge incentives to double their bets in the hope of returning to positive territory, where they can re-charge their fees.

Importantly, the criteria should be broadened to take account of tax and regulatory arbitrage practices, which are at the roots of the business of hedge funds. The large majority of hedge funds are located in, or have a substantial part of their transactions passing through, offshore financial centres (OFCs). OFCs – where over USD 6tr are located according to OECD estimates – impose tax secrecy and cost EU taxpayers billions of euros in tax evaded revenues every year.<sup>1</sup>

Such a scoping exercise should also focus on the powerful interests that bind the hedge fund industry to the banking sector. Commercial and investment banks have not only got very close ties with the industry; they are often personally connected to the funds. Many hedge funds were founded by former investment bankers and banks often house hedge funds as part of their prime brokerage services, or have created products that duplicate hedge fund strategies.

#### *2) Effectiveness*

With regard to “effectiveness”, despite the international dimension, TUAC considers that a “purely European response” would nonetheless be effective as it would set in motion a

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<sup>1</sup> According to the OECD report of October 2008, “Ireland recently recovered almost €1 billion in an investigation into accounts held in offshore banks. The United Kingdom has recovered almost £500 million through its voluntary disclosure facility.” <http://www.oecd.org/dataoecd/19/13/41405382.pdf>

broader move toward re-regulation of financial markets, maintain level playing field among the various forms of collective investment schemes and importantly the phasing out of the shadow banking. Incidentally it would also contribute to ending one of the sources of funding of OFCs, which cost EU tax payers billions of euros per year.

The impact of such European response obviously would be enhanced should it be closely coordinated within the G20 Process, as we argue above, and in particular with the US Administration and Congress, and key international organisations, including members of the Financial Stability Forum. However, international coordination per se should not become a pre-requisite but should follow suit a much needed European initiative on regulation of hedge funds.

### ***Systemic risks***

So far, the prevailing view in international fora, such as the Financial Stability Forum (FSF) and its members has been to exclusively rely on “delegated supervision” of hedge funds. Rather than regulating hedge funds themselves (the investment firms and the limited partnership that govern the funds they run) the attention of regulators and supervisors has been on the regimes applying to the counterparties: hedge funds’ creditors, investors (including pension funds) prime brokerage, investment banks and other firms that provide back office accounting and settlements services to hedge funds. Ensuring proper risk management by the counterparties would alone ensure supervision “by delegation” of the hedge funds. For example, there is no need to closely supervise the funds managed by Mr Madoff, we were told, because the counterparties – *inter alia* UBS, Banco Santander, BNP Paribas – are themselves highly regulated and have in place sophisticated risk management systems for *vis-à-vis* their holdings in the hedge funds run by Madoff.

The delegated supervisory approach has created major imbalances in the global financial regulatory framework and major challenges for regulators and supervisors. Public authorities cannot properly monitor the hedge fund industry, including its role in the building of asset price bubbles, but have to rely on various channels: reporting by commercial banking and investment banking, primary brokerage, investors, creditors, credit rating agencies, etc. This has become an impossible task given the fragmented and silos approach of financial regulation in Europe.

In our view the credit crunch and the deepening of the crisis in September 2008 show that delegated supervision alone cannot substitute for the needed “direct regulation” and supervision of hedge fund investment firms and of the limited partnerships that govern the funds they run. As such, we fully support the European Parliament Resolution (September 2008) on hedge funds and private equity. A number of European governments have similarly expressed public support for such approach. For example the EP Recommendations are reflected in a contribution by the Danish government to the Council, dated November 2008, notably on the creation of an EU-wide harmonised regulation framework for registration and authorization of hedge funds (alongside private equity) and upper limits on debt financing and regulator capital requirement for hedge funds.<sup>2</sup>

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<sup>2</sup> <http://www.folketinget.dk/doc.aspx?/Samling/20081/almdel/EUU/bilag/108/index.htm>

### ***Micro-prudential risks and transparency toward investors***

An inherent tension, if not contradiction, exists between the characteristics of hedge funds and the very principles of regulation of and transparency in the market place. Such resistance to re-regulation and increased transparency is not specific to hedge funds. Any private market player is concerned by the short-term cost implied by regulatory compliance, and the protection of business confidentiality, especially when engaging in highly complex transactions. However hedge funds, like other private pools of capital such as private equity, are far more opaque than that which is necessary for business confidentiality purpose. In particular, hedge funds managers use proprietary models for their investment policies and therefore are reluctant to meet any transparency requirements. For individual hedge funds to willingly reveal their investment policy and positions would be too much to hope for.

Recent initiatives aiming at “self regulating” the Industry are very telling in this regard. The EC paper makes reference to the much publicised UK-based “Hedge Fund Standards Board best practices which were released early 2008. By the end of the year, however, according to a survey of the British hedge funds, only 10% had “plans to sign up” to the standard, nearly a fifth said they would “definitely not comply” with its requirements, and two-thirds had “yet to make a decision”, while none had been asked by investors to adopt the best practice standards.<sup>3</sup>

Opacity is also a characteristic of the legal structure of the funds. Limited Partnership agreements (LP) form the legal basis for the hedge funds and rule the rights and duties of limited partners (the investors) and the general partner (the hedge fund manager). LPs are very un-evenly addressed by regulation across Europe and in any case are open to any form of abuse and restrictive governance schemes given the heterogeneity of regulatory regimes and the widespread use of OFCs. Although there is little information, it is understood that the content of LP agreements runs counter to the reforms and changing practices toward more responsible and active institutional investors. In fact, when compared with shareholder activism in listed equity AGMs, the LP is a return to the ‘Stone Age’ of governance.<sup>4</sup>

### ***Market efficiency and integrity***

Hedge fund short selling strategies based on share lending should be thoroughly addressed. Any form of trading that is not tied to the effective ownership of the underlying asset – as is the case in share lending – is in our view a source of deep suspicious *vis-à-vis* the integrity of the market and should be severely restricted.

Although not specific to hedge funds, the Commission should also investigate the impact of hedge funds that specialise in shareholder activism on the sustainability of the target listed companies.

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<sup>3</sup> <http://www.kinetic-partners.com/public/downloads/KP%20HFSB%20survey.pdf>

<sup>4</sup> Speaking of investments in private equity, British pension expert Paul Myners said “investors can be quite lethargic... [we] should ask why they invest in private equity with its association with aggressive capital structures, high incentives for management and a minimalist approach to governance ... while adopting an entirely different approach when investing in public equity”. (House of Commons, Hearings on private equity, June 2007). There are reasons to believe that such double-standard behaviour by institutional investors also applies to investments in hedge funds.

***Annex: indicative list of trade union statements referring to hedge funds***

Re-regulation in the Aftermath of the Global Financial Crisis, TUAC Position Paper, November 2008; [http://www.tuac.org/en/public/e-docs/00/00/03/91/document\\_doc.phtml](http://www.tuac.org/en/public/e-docs/00/00/03/91/document_doc.phtml)

The Financial Crisis and the Economic Recession: A Turning Point for Casino Capitalism, ETUC Position Paper, October 2008; [http://www.etuc.org/IMG/pdf\\_Item\\_5\\_casino\\_capitalism\\_EN.pdf](http://www.etuc.org/IMG/pdf_Item_5_casino_capitalism_EN.pdf)

Hedge Funds: Issues for Trade Unionists, UNI, August 2008  
<http://www.uniglobalunion.org/etc...>

Where the house always wins: Private Equity, Hedge Funds and the new Casino Capitalism, ITUC, June 2007; [http://www.ituc-csi.org/IMG/pdf/ITUC\\_casino.EN.pdf](http://www.ituc-csi.org/IMG/pdf/ITUC_casino.EN.pdf)

Socially Responsible Investments, Hedge Funds and Private Equity, FNV, March 2007; [http://www.fnv.nl/binary/Socially%20responsible%20investments\\_tcm7-15719.pdf](http://www.fnv.nl/binary/Socially%20responsible%20investments_tcm7-15719.pdf)

Bevan Memorial lecture: The Challenge of the New Capitalism, John Monks General Secretary, ETUC, November 2006; <http://www.etuc.org/a/3052>

Investment Chains - Addressing corporate and investor short-termism, TUC, March 2006; <http://www.tuc.org.uk/pensions/tuc-11565-f0.pdf>