January 30 2009

PES Answer to consultation on hedge funds

Introduction

Hedge funds cannot be analysed in a fair and consistent way without placing these funds in a broader context. And this context is the real economy in the European version, i.e. the welfare states. In 2000 in Lisbon the European Council defined the strategy for making Europe “The most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth, more and better jobs and better social cohesion". This was confirmed at the Spring European Council 2005.

We need investment to make our welfare societies more competitive in the global economy. The very basis for Europe in the global economy is a pro-active European industrial policy, focusing on knowledge and information, and smart green growth. But, to achieve these objectives, long-term investment is crucial. And to serve that purpose, we need a well-functioning, transparent, cost-effective and stable financial market.

Financial markets are a tool, and not an end in themselves; they are supposed to serve and enable the real economy to be more productive.

The decisive question is - to what extent the growing sector of “alternative investment funds” - the hedge funds and private equity funds - conform and contribute to a positive, efficient and long-termist role for the capital markets in financing the enormous amount of investment needed in the real economy? Unfortunately, we have seen some activities of hedge funds being inimical to the wider social interest, extracting rather than creating value, and leaving others in the society to pick up the cost!

Overwhelming evidence and practical experience show that many of their activities raise serious concerns and problems in the real economy, e.g. the impact on long-term investment in R&D, new technology etc. in co-operative businesses, jobs and working conditions, investor protection and systemic risks to the stability of the

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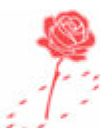


financial markets.

We deeply believe in a transparent, well-regulated market economy as the basis for the social economy in our welfare states and in the future global economy. Otherwise, as the actual financial crisis have shown us, we will simply weaken the future of our companies, industries and services, and the capability to be at the front of the added value chain, which requires constant high investment in knowledge, research and advanced employment - more and better jobs. And our Lisbon goal - "to become the most competitive and dynamic knowledge-driven economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion" - will surely be under threat.

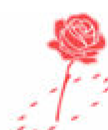
In recent years – long before the current financial crisis first emerged in August 2007 – there have been growing concerns about the effects of the activities of highly leveraged investment vehicles such as hedge funds. These concerns have been voiced in Member States and by European and global financial institutions. Hedge funds are no longer a "niche" industry, but important actors in the financial markets.

Given easy access to debt financing with low interest rates and high liquidity from 2000 to mid-2007 and the search for higher yields by many institutional and other investors, the share of hedge funds within the global asset under management (AuM) pool has increased substantially. Not only amazing growth of their assets but also ever more intensive trading activities make these vehicles important market players. In recent years hedge funds here accounted for more than 50% of the daily trading volume in equities markets. As essential part of their business activities, Hedge Funds have also been amongst the leading buyers and sellers of many of the credit derivatives and other structured products that have been at the heart of the actual financial crisis.
Although their weight in the markets has increased, the same cannot be said for the levels of transparency[1]. But even if the hedge fund industry - and the private equity industry - are major financial actors on the market, they are still exempted from any direct EU-regulation.

Until June 2007 – a few months before the global financial crisis emerged – concerns about systemic risks and pro cyclical behaviour were expressed in several independent reports by global financial institutions and also highlighted at several international meetings. In May 2007, the Financial Stability Forum recommended new actions to be taken by financial authorities, institutional investors and hedge fund managers to strengthen protection against potential systemic risks related to hedge funds and other highly leveraged institutions. Similar concerns were expressed by the ECB in reports dating back to 2006 and 2007.

In the legislative report from the European parliament on hedge funds and private equity (2007/2238(INI)), which was agreed by a broad majority in the parliament, it was expressed in paragraph one that "all financial actors must be covered by better regulation, including hedge funds and private equity". This was confirmed by the French Presidency of the European Union, and again recently by Mr. Hervé Novelli at a debate in the European Parliament on December 3rd 2008:

[1] See Working Document on hedge funds and private equity, 17.3.2008: http://www.europarl.europa.eu/meetdocs/2004_2009/documents/dt/714/714525/714525en.pdf



"*Monsieur Rasmussen, je voulais vous indiquer, même si votre intervention s'adressait plutôt à la Commission, que je vous suivais dans l'insistance que vous mettez pour dire qu'aucun segment de marché ne doit échapper à la régulation ou à la supervision*."

And Commission President Barroso's letter of December 12th 2008: "*It is clear that as we gain new insights into this crisis we have to draw the consequences for our financial regulatory and supervisory structure. New regulation will be required. No financial player should be exempt from regulation and oversight. That is a clear commitment on our part. It means that hedge funds and private equity must be covered*."

And about the consultation he added in the same letter: "*To be clear, the purpose of the consultation is not to decide whether or not appropriate regulatory initiatives will be taken. It is to decide on the content*."

On this background, we are a bit astonished to read in the introduction of the consultation paper of the Commission that: "The Hedge Fund sector is one area where the need for further work - Starting with an analysis of self-regulatory actions - will be needed."

We disagree - the experience from self regulatory schemes for companies or managers have shown us, that it's not working. And the recent enforced idea of self-regulation in the form of codes of conduct from the Hedge Fund Industry is clearly proposed - and confirmed openly to the media by the industry itself - with the aim of avoiding direct regulation.

We also find it directly self-contradictory when the commission in its proposal for regulation of other major actors such as Credit Rating Agencies, reject the idea, that self-regulatory codes of conduct are sufficient.

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1. Scoping the issues

When trying to create the complete basis for better regulation, one need to include all relevant questions related to Hedge Fund activities.

We are astonished, that the Commission has left out some major issues, although the European Parliament has specially requested that the following issues be addressed:

- Capital adequacy requirements
- Compensations based on long term incentives
- Leverage
- Impact of market concentration

We will therefore deal with these very important questions as part of the consultation.

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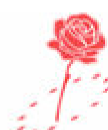


As this crisis has highlighted, the financial system is now highly inter-connected and highly geared. Distress in one institution leads to forced asset selling and because many financial institution assets are now “marked to market”, the resulting fall in asset prices can cause financial stress in other institutions through marked to market losses.

These institutions are then, in a bid to reduce risk and maintain capital ratios, forced to sell some of their liquid assets which can then trigger an asset price fall – loss – forced de-leveraging and forced selling downward spiral which can result in a systemic breakdown.

Even if such systemic breakdown is prevented, any form of market stress imposes significant costs on a whole host of other financial institutions and often also the real economy. Importantly, this total cost to the system or to society is much higher than private cost to the institution where the financial stress originates.

So, financial disturbances in a hedge fund (or any other significant financial institution) have significant negative externalities. **Such potential negative externalities are perhaps the most important reason to regulate hedge funds.**

Question by question answers

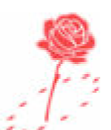
1) Distinction between hedge funds and other actors: what elements should be taken into account? Do their distinct features justify a targeted assessment of their activities?

The description provided by the Commission to explain how hedge funds operate and who are the main actors in the business, is partly relevant, when it raises the question of various existing forms and patterns, use of leverage and recourse to specific techniques (derivatives, short selling).

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.

This is why in addition to targeting hedge funds *per se*, it is also important to tackle the very same type of activities undertaken by other actors, such as investment banks, insurance or more traditional mutual funds, in particular in connection with “in-house” hedge funds. Similar strategies used in the context of “managed accounts” and closed-end funds must also be addressed.

In quite many aspects hedge funds act like unregulated banks. Hedge funds have significant business relationships with ***regulated investment and commercial banks***. The latter act as prime brokers (including financing trades), as well as provider of trading, sales and other services such as clearing and settlement, custody and even offering office space to hedge funds managers. There are estimates that hedge funds have provided investment banks with revenue of 40-50 billion USD in 2006, which was roughly around 15-20 percent of all industry revenues in investment



banking, and equivalent to 4 percent of the assets under hedge funds management at the time.[2]

We firmly believe, hedge funds should be subject to regulation under the purview of

1) consumer protection
2) investor protection
3) market integrity
4) potential negative externalities especially their potential impact on financial stability

Additionally, they should also be subject to the ad hoc emergency regulations that need to be introduced from time to time such as the recent ban on naked short selling.

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

It is often used as an argument against EU-regulation that only globally-harmonized regulation works. We think that this point of view has also been used by the industry in order to escape better European regulation. Therefore, this question is too naive to be neutral and deserves both a technical and a political answer.

Ultimately, it depends on what we are trying to achieve. We try to answer this question from the perspectives we considered in the preamble of this document.

Consumer protection

European legislation on this issue needs to be both bottom up and top down. Top down means that European hedge funds should be prevented from marketing and selling their products to everyone outside of a restricted list of sophisticated investors.

In order to make sure that non-European hedge funds do not arbitrage a more lax home regime, we also need to have legislation 1) prohibiting any hedge fund from marketing to retail customers and 2) making sure that only qualified and registered 'advisers' are allowed access to retail customers and these should then be prohibited from marketing hedge funds at the risk of losing their license and even personal liability.

Investor protection

Minimum investor disclosure rules need to be in place for European hedge funds. We believe that while it would be impossible to protect all European sophisticated investors from "insufficient disclosure" by non European funds, investors in this post sub-prime, post Madoff financial landscape will become more demanding and discerning.

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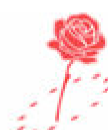
[2] Dresdner Kleinwort: "Credit Swiss, Deutsche Bank, UBS: How important are hedge funds for the investment banking industry?", Dresdner Kleinwort Equity Research, 6 February 2007, p.8.



In fact, we firmly believe that mandatory minimum disclosure requirements and a more robust regulatory regime will give European hedge funds a sharp competitive edge as investors seek more reassurances and security and become more cautious.

Of course, we should still strive for globally binding minimum disclosure and investor protection rules etc.

Market integrity

Most of the practices that threaten market integrity are already illegal under existing regulations. In many cases the solution is to apply these regulations more rigorously.

What if foreign based hedge funds try and manipulate European markets? There are two possible ways to address this. One is to hold the European entity (brokerage or dealer etc) through which foreign hedge funds indulge in unscrupulous activities accountable. This would create incentives for such institutions to do better due diligence on the activities of their foreign hedge fund clients.

The other way is to introduce a pre-registration provision for foreign hedge funds before they are allowed to take positions in European markets and to ensure that funds that are allowed to trade in Europe have a comparable home regulation regime.

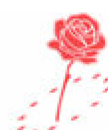
This will not put Europe at a competitive disadvantage, because Europe is too big and too important for most diversification strategies and for most hedge funds to choose not to invest in.

Financial stability

This is dealt with in the next answer in more detail. The only point we will make here is that ideally we need global solutions to dealing with the potential systemic impact of hedge funds. However, purely European legislation would still be a step in the right direction and the benefits in terms of lower systemic risk through better prudential norms would far exceed any potential costs in terms of a loss of competitive edge.

On the technical side, it is true that with global capital flows, a purely European response may appear as insufficient; however, as the example of Credit Rating Agencies shows us, it is technically conceivable to implement a European regulatory framework to global actors/activities, due to their systemic importance. EU regulation of banking activities is another example. On the political side, it might be true that a global response is more than desirable but very difficult to reach. So far the G20 has been very cautious on the issue of hedge funds but the EU has a leading role to play in promoting a certain convergence among regional regulatory and supervisory frameworks. The creation of a European framework would not prevent hedge funds to continue their activities on European markets, and would not prevent other parts of the world to have/develop their own framework, keeping in mind that convergence is the key to overall stability of the financial system.

To ensure an effective and competitive single financial market in Europe, the European Commission should establish an EU framework for the registration and



authorization of hedge funds and entities that control the investment of hedge funds which should function on a single entry point basis: once authorized, the entities concerned should have access to undertaking business throughout the EU. It's interesting to see, that similar thinking is developing in the US (Group of 30-Report).

Our view is to create common EU-rules for European hedge funds (either single strategy, or FOHFs) in order to create a unitary category of onshore funds with a common minimum investment threshold, which could be lower in the case of FOHFs. By definition, it will never be possible to prohibit offshore funds at a worldwide level. So it seems more realistic to develop an onshore regime able to compete with offshore funds: it would obviously not prevent some investors keeping their activities secret in offshore funds but it would offer an alternative choice for the rest of investors, through a higher level of safety, a guaranteed level of professionalism of fund managers, an overseeing by regulators. Thus, such EU regulated products will be offered as an alternative to offshore funds. And the features of such onshore products will reduce the size of the offshore market as compared to the onshore one. This EU regulated regime would not forbid Member States to keep nationally regulated regimes. It should be mainly designed for the needs for regulation of the professionals and the structures involved in the 'value chain': hedge funds, management companies, administrators and depositaries/prime brokers. It would focus on the following issues (as shall be adapted to the specificities of each category of professional): registration of these professionals in the EU, requiring that they are 'fit and proper persons', minimum capital and liquidity requirements and minimum rules on valuation of assets. The extent to which such professionals should be regulated would depend on their specificities (such as strategy, risk, leverage, instruments they use, etc.), their location and the location and nature of investors (for instance, specific requirements should be applicable if investors include EU commercial banks, insurance companies or regulated collective investment schemes).[3]

Such an EU system could also pave the way for the G20 for a worldwide system.

2. Systemic risks

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

Yes, the concern on systemic risk is that a large number of hedge funds, as well as other actors, employing similar strategies in the markets would increase the volatility of financial markets through momentum trading. Fierce competition for hedge funds' business could force some banks and securities firms to relax their risk management measures, allowing hedge funds to increase their leverage and exert an even bigger influence on the volatility and liquidity of the financial markets. 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

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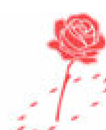
[3] It should be noted, regarding the territorial scope of regulation, that different approaches are used in existing legislation: for instance, in the UK, management companies are registered on the basis of their location, while investment advisers in the US are registered on the basis of the number of investors who are advised.



light of the financial crisis. Although they are probably not at the source of the crisis, they have significantly contributed to its propagation: for instance, acquisition of a substantial portion of CDOs has led to an increased indirect exposure of institutional investors to such products.

It is wrong to suggest that a regulatory "tool-box" for hedge funds should not comprise capital reserves. The reality and practise show that hedge funds usually keep some capital reserves to cope with ups and downs: why wouldn't some reserves made mandatory in certain circumstances? The reduced short-term returns that may result from such types of requirements should be balanced with long-term returns (including reduced failures of over-risky hedge funds) and the benefit of a reduced systemic risk.

Recently more funds have been turning to increasingly exotic strategies and less liquid markets in order to earn the associated liquidity premium. This increases the vulnerability to risks in the advent of a crisis. Thus, in stressed times, a squeeze can arise especially in less liquid markets. When several hedge funds, that are pursuing the same strategies, rush for cover, liquidity evaporates suddenly in those market segments. Instead of bringing in liquidity, hedge funds generate major liquidity risks. The mix of credit and liquidity risks in investment styles using short selling-come-leverage can make hedge funds the weak links initiating a systemic event. If hedge funds are induced to withdraw together from the same markets under the constraint of a higher cost of financing or margin calls, the forced selling of assets could trigger the same behaviour among more traditional institutional investors. This could in turn spark a financial crisis. In essence, hedge funds have used short term financing for investment in non liquid assets, acting as *de facto* non regulated banks.

As we have seen in the past (LTCM) our perspective is that 1) hedge funds could easily have caused or triggered a crisis and 2) forced asset sales by hedge funds have helped exacerbate the ongoing crisis so has had indirect systemic consequence both in terms of the scale of the crisis and the magnitude of tax payer bail outs needed.

They use leverage (in a number of cases this leverage is very high) and they have serious asset-liability mismatches. Another reason to be concerned about the potential systemic impact of hedge funds is that they have grown ever bigger and ever more interconnected with the rest of the financial system.

However, all hedge funds are not the same and what regulators need to do is to distinguish between those that are systemic – (due to their size and/or leverage and/or asset-liability mismatch and/or inter-connectedness) and those that are not. And this assessment has to be updated regularly over time.

There is a need to have more stringent supervisory and regulatory requirements for systemic funds including but not limited to 1) minimum capital adequacy ratios 2) minimum liquidity requirements and 3) other appropriate prudential norms such as restrictions on leverage .

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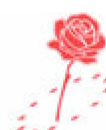


4) Is the "indirect regulation" of hedge fund leverage through prudential requirements on prime brokers still sufficient to insulate the banking system from the risks of hedge fund failure? Do we need alternative approaches?

The answer to the question about indirect regulation is definitely NO. It is insufficient for the following reasons: It could be argued that this indirect regulation was useful to insulate the banking system from hedge fund failure but to which extent the recent failure of banks was speeded up by the pro-cyclical behaviour of hedge fund, 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. It also does not prevent the consequences of hedge fund 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.

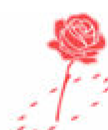
This indirect approach seems increasingly insufficient, because Investment Banks as Prime Brokers are increasingly active in proprietary HF, which constitutes an obvious conflict of interests.

Indirect regulation assumes that Hedge Funds counterparties are adequately regulated and supervised *in their business with hedge funds*. It also assumes that they have an incentive to comply with.

Hedge Funds counterparties are prime brokers who are big multinational banking groups, either American investment banks or investment branches of gigantic American financial conglomerates like CitiGroup or Bank of America and European universal banks. For effective indirect regulation, bank supervisors must have a proper understanding of the risk exposure taken by banks on hedge funds, so that they can check if the risk is adequately accounted for in Basel II capital provisions. At best, regulators can only know the total net exposure of a bank to all hedge funds. But they do not know the exposure of any hedge fund provided by all counterparties. Therefore the nature and the ever-changing size of Hedge Funds liabilities to their lenders make illusory the knowledge of the relevant indicator of leverage risk due to hedge funds, which is *potential future credit exposure*.

The feasibility of indirect regulation via banks is dubious, at least debatable. In any case it cannot be taken for granted. And even if it were, banks have no incentives to be the regulators’ scrutinizers of hedge funds for two reasons:

- On the one hand, banks are busy acquiring or setting up hedge funds themselves. They are doing so to boost profits by all means, prodded as they are by shareholder value incentives.
- On the other hand, prime brokerage for hedge funds is sold with a whole bundle of services (clearing, settlement of transactions, custody of assets, research, legal advice and the like). This is a very profitable but risky business. Likewise, securities lending is yet another source of remuneration and also created – while bearing risk –high revenues. The more business volume they get, the better.



Furthermore, monitoring the extensive use of derivatives is crucial. The global hedge funds' leverage is ruled by a very restricted number of prime brokers. So the first task of financial authorities should be to ask prime brokers for a periodic full disclosure of the exposure (fund by fund and then of the whole client base) to different categories of financial risks. *Potential future credit exposure should be measured and stress testing performed.*

We firmly believe that those hedge funds deemed 'systemic' – see previous answer – should be subject to direct prudential supervision. The prime broker route may be used for 'non-systemic' funds.

Prime brokers face significant conflicts of interest in terms of earning large fees from hedge funds. They cannot be wholly relied on to monitor and impose prudential norms. As has often been the case (remember LTCM?) prime brokers often sacrifice good practice for higher profits. A higher capital charge on lax prime brokers may help align incentives better but is clearly a second best solution.

Another problem is that most large hedge funds use multiple prime brokers so no one broker is in a good position to monitor their activities.

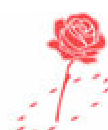
Direct regulation is necessary on top of the existing indirect approach. It is necessary to address the various issues created by hedge funds with a diversity of regulatory instruments; one unique tool (such as the indirect approach) would not be sufficient to address several issues.

Whatever the legal structure of hedge funds, appropriate capital and liquidity requirements should be introduced at the level of the fund, covering all funds regardless of their place of registration, to the extent EU pension funds, commercial banks, collective investment schemes or insurance companies are among their investors. Appropriate capital and liquidity requirements should also be imposed to such EU institutional investors when investing in hedge funds, with appropriate rules to make sure that there is no loophole in the implementation of the requirements and that no double protection is unnecessarily imposed.[4]

In addition, the Commission should introduce risk-weighted capital adequacy requirements in respect of liquidity risk and the capital requirement of any institution providing prime brokerage services should be increased in line with the complexity and opacity of the structure or nature of the exposures, to which their dealings with hedge funds expose them. In particular, the provisions of Directives 2006/48/EC and 2006/49/EC should be amended to achieve that result. For new products the maximum risk-weight has to apply as long as there is not a minimum 3 years track-record. Perspective downscaling of the risk-weight has to be approved by the supervision authorities.

Hedge funds and hedge fund management companies should also be subject to appropriate rules regarding bonuses and compensation, in order to limit pro-cyclical conduct and *moral hazard* resulting from a system providing for high bonuses in the

[4] Any capital and liquidity requirements at the level of institutional investors would take into account the existence of capital and liquidity requirements at the level of the fund.



event risky strategies succeed, and no reciprocal downside in the event of failure. These rules would be applicable when investors are EU pension funds, commercial banks, collective investment schemes or insurance companies.

Other avenues should be explored, such as requiring management companies to invest their own funds in hedge funds they manage, in proportion to the risk of the strategy they implement.

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?

One of the reasons why the supervisory authorities did not intervene earlier during the development of this financial crisis is evident: Prudential authorities have probably neither a precise idea of the exposures encountered by hedge funds counterparts, nor a view of the price movements affected by hedge funds. If it had been otherwise, some warnings would have been sent before failures or some vicious circles stopped.

The introduction of strict reporting requirements on 1) capital 2) leverage 3) investment strategy 4) investment portfolio 5) links with systemic financial institutions 6) source of funds and 7) risk management metrics is essential and overdue.

It is of course essential to ensure the confidentiality of some of this information which is proprietary in nature and this can be done by ensuring that such disclosures are only made to the macro-prudential authorities which in most cases would be the central bank.

Some of this information is of course relevant to and can be shared with other stakeholders and where concurrent disclosure may not be appropriate, suitably lagged disclosure might work.

It is imperative that financial authorities have an accurate picture of the state of the financial system including aggregate amounts of capital, leverage and risk as well as inter-linkages amongst various actors.

Disclosure of such information to the regulatory authorities will also ensure that the scope for market abuse and market manipulation is significantly reduced, which also has second order positive benefits for systemic stability, as a large scale prevalence of such activities can erode confidence in the whole financial system.

The European Commission should, with the help of Level 3 Committees, establish an EU-wide registration/authorization database recording the information on both management firms and investment vehicles as specified above. The supervisory authorities of all Member States should have unlimited access. Relevant categories of the database should be public – appropriate disclosures could also have the effect of fostering competition between hedge funds, thus bringing down the level of fees for the benefit of investors. Registered entities should provide supervisory authorities with periodic reports.

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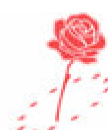


3. Market efficiency and integrity

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?

Hedge funds have often been given credit for enhancing market liquidity amidst figures which show how significant (and growing) a proportion of particular financial markets (such as the NYSE) trading their activity constitutes. This is then often used to say that they have increased the efficiency of financial markets, also as liquidity providers.

As the Porsche case in Germany has proven in the last months, on the contrary unrestricted activities of hedge funds deteriorated and destroyed the price-formation, first of one of the largest European companies, and then of the largest national share-index (DAX). Many funds, which have to mirror the development of such indexes, suffered losses due to this effect.

We know that this liquidity, based on excessive leverage, was part of the problem in the crisis. The temporary restrictions on short-selling did not prevent stock prices to fall but one could imagine many more failures of banks and insurance companies in case this practise would have continued.

Furthermore, three additional points should be made here:

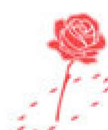
1) Many of these markets, which the hedge funds have supposedly helped make more liquid, were already highly liquid. No one would say that the NYSE was illiquid before the hedge funds started playing a significant role. In fact there is a saturation point beyond which an increase in the number of transactions does not contribute to greater liquidity in the markets.

2) True liquidity in the financial markets comes from a diversity of opinion amongst market players. To the extent that Hedge funds were contrarian investors, they contributed to greater liquidity but evidence shows that a majority of hedge funds simply run with the herd and are more leveraged versions of more conventional investment vehicles. These simply make the financial system more pro-cyclical and so perhaps contribute to less efficient markets.

3) Some of the new markets such as Credit Default Swaps where hedge funds were significant market players have not worked so well.

Being allowed to short sell means that hedge funds can contribute to increasing the efficiency of the price formation process by, for example, allowing them to take bets against bubble valuations in assets which can help reduce the likelihood of damaging asset price bubbles forming in the first place.

In that sense, short selling restrictions can harm the efficiency of financial markets. However, it is necessary to protect against abusive practices that allowing naked



short selling can engender – such as selling off more shares than are outstanding and available for purchase.

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

Yes, when short-selling does not have the purpose to correct over-valued securities but rather to make last minute profits to the detriment of the viability of the company listed. If short selling is to be restricted, this should apply not only to financial institutions, but to all companies, as their situation is also disrupted by this practice. To discourage the speculative impact, naked short selling should be abolished or subject to a specific permit.

It is only a limited segment of hedge funds that is actually practicing short selling. Yet those who do are often charged of being trend-setters, i.e. of causing price depreciation independent of the underlying market fundamentals. 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. This is especially the case in smaller illiquid markets.

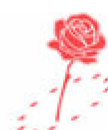
To give one example for a large market: an article of the Washington Post dated 20 August 2008 reports that 81% of the oil contracts on the NYME are made by financial firms for speculating purposes.

When short selling becomes a significant share of the outstanding 'free stock' of a company available for trading, price signals can get distorted. Also, restrictions might be warranted in the event of a run on particular sector of the kind that the finance sector experienced recently.

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

The current crisis has shown how detrimental or destructive the practise of short-selling can be. Therefore, tightened controls appear to be necessary, not only on hedge funds but on all market players. Short selling can easily be abused as it has happened often in the recent past when short selling has been accompanied by marker rumours started by the same hedge fund which allow it to make a large but unscrupulous profit when the markets react to those rumours.

More specifically, "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 threat to the well functioning of financial markets.



Integrity of financial markets may also be threatened when short-selling is coupled with empty voting, as this may in particular lead to opaque practices resulting in inappropriate prices.

While tackling this falls within the purview of general market discipline, mostly hedge funds are the biggest short sellers so the regulation needs to be designed keeping them in mind.

4. Management of micro-prudential rules

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

Systemically significant hedge funds (see previous answers) need to be subject to macro-prudential as well as micro-prudential norms. The micro-prudential norms here would include tighter supervision as well as specifications along the lines of 1) better operational risk management (half the hedge funds fail because of bad operational risk management practices) 2) better market risk management and 3) better liquidity risk management.

Mandated Independent third party assessments of 1) capital adequacy 2) adequate liquidity 3) operational risk and back office practices and 4) valuation would also help improve risk management and are essential for systemically significant hedge funds.

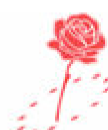
Together with these, appropriate compensation structuring regulations as well as disclosure norms and counter cyclical norms that are agreed need to be applied to systemically significant hedge funds in order to ensure better risk management and administration practices.

Minimum reporting standards should be established to fully disclose the strategy of the fund with its risk categories and the risk management model adopted by the investment managers – this should include modelling of potential risks, management fees, stress testing of portfolios plus descriptions of contingency plans to contain risks.

Valuation of funds should also be made by independent administrators. While this is common practice in Europe, it is not always done, thus leaving loopholes in the system and creating a potential “race to the bottom” in investor protection. The Madoff case is a recent and striking example of why independent valuation should always be warranted.

5. Transparency towards investors and investor protection.

10) Do investors receive sufficient information from hedge funds on a pre-contractual and on-going 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 contractual arrangements which foresee the level of information disclosed from the hedge fund to the investor should become part of a new regulatory framework, containing details as regards the type and quality of information to be provided. This would guarantee the same level of investor protection.

When hedge funds are distributed to retail investors, specific provisions should be added. Experience shows that appropriateness and suitability tests are too formal and do not avoid wrong investment decisions. This has to be reinforced in the existing regulatory framework of Mifid.

Concerning valuation, the Commission should propose precise rules on the valuation of illiquid financial instruments in order to better protect investors and the stability of financial markets.

In order to promote a well-functioning single European financial market, the Commission should ensure the investment vehicle discloses the following information to the investors:

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

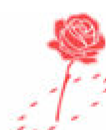
Regarding the risk profile, specific information should be given on the sensitivity of the strategy to rare events and clear explanations should be provided when the risk distribution profile does not follow the standard “bell shaped” curve. Concepts such as kurtosis and skewness should be presented and described in a clear manner.

This would be achieved via a directive, together with the registration principle.

The European Commission and supervisory authorities should ensure that investors in those vehicles receive not only sufficient but also relevant and comparable information.

In order to promote a well-functioning single European financial market, the Commission should also ensure that management firms of hedge funds disclose the following information to obtain authorization:

- The name and domicile 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.

That information should be set out in a uniform format (also to facilitate the proposal for a database).

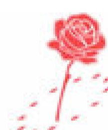
In addition, EU pension funds, commercial banks, collective investment schemes and insurance companies should be under the obligation to demonstrate at all times to the competent authorities for each hedge fund they are investing in that they have a comprehensive and thorough understanding of and have implemented formal policies and procedures for analysing the investment their investment and the risk attached thereto. The details of such rules could follow the pattern of the proposed article 122a of the revised Capital Requirement Directive.

Regarding compensation issues, the so-called “high water marks” provisions should also be assessed in the light of current experience. Although they are supposed to protect investors from payment of incentive compensation when the performance has not been effectively improved, they tend to be renegotiated in the event of significant market falls. They may thus appear to be deceptive to investors. Further work should be done to review this issue.

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. Especially in light of the recent developments, the access of retail investors to hedge fund should not be facilitated. Retail investors have other and more adequate investment opportunities through UCITS for example and it is likely that the pattern of hedge fund strategies, with assets locked-up with a relatively long time period, do not match with retail investors' needs.

The added value that hedge funds bring to retail consumers is questionable, while the development of the market introduces significant risks (see below). Although a strong consumer policy case could be made (based on the precautionary principle) for a prohibition of the distribution of hedge funds (and similar asset classes) to retail investors, it is probably not politically viable, given the current emphasis on market liberalisation within the EC. However, it is certainly reasonable to argue for a set of robust regulatory interventions to manage the potential detriment to retail consumers. It goes without saying that a hedge fund scandal similar to those seen in the US would undermine the limited potential for the sector and damage the reputation of EU policymakers. The previous Commission expert group made some consumer protection recommendations: a minimum investment threshold of Euro 50,000 and for the enforcing of clear conduct of business requirements on the intermediaries and institutions who conclude sales contracts with end-investors. These measures provide only limited protection – for example, the minimum investment threshold could easily be circumvented in cases of large pension transfers. However, the main flaw in these recommendations is that they do not sufficiently address the numerous key risks such as: legal and governance issues, prudential supervision, conflicts of



interest within the hedge fund system, valuation risks, disclosure, promotion and marketing issues, intermediary competence, and risk classification.

In the case of retail consumers, the asymmetry between the average hedge fund and the average retail customer is so high that it makes sense to have :
1) Restrictions or prohibition of direct exposure through hedge funds being unable to offer products to retail consumers and
2) Restrictions on indirect exposure through a) limits on pension fund and bank exposure to hedge funds b) a special vetting process or a positive list for hedge funds where such retail vehicles such as pension funds and banks are allowed to invest c) a total prohibition even of such second order exposure for the retail consumer.

“In short, few would think it appropriate that granny Tina’ life savings are invested in hedge funds.”

Last but not least, the Commission should evaluate the retail-impact of the Lehmann bankruptcy for European retail-investors and their consumers’ view on to what extent the existing schemes on mandatory advise and client’s risk strategy assessment have worked.

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