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WORKING DOCUMENT OF THE COMMISSION SERVICES (DG INTERNAL MARKET)

CONSULTATION PAPER ON HEDGE FUNDS

1. INTRODUCTION

The financial crisis has exposed a series of vulnerabilities in the global financial system. It has also underscored the powerful interdependencies that exist between financial market actors and has demonstrated how rapidly risks crystallising in one sector can be transmitted around the financial system. In order to draw meaningful lessons, it is therefore necessary to take full account of the actions and interactions of all major financial market actors in triggering the crisis and amplifying its effects.

The European Commission is currently conducting a comprehensive review of the regulatory and supervisory framework for all financial market actors in the European Union, in line with the G-20 objective to '*ensure that all financial market products and participants are regulated or subject to oversight, as appropriate to their circumstance'*.

In areas where market failures have been clearly identified, targeted work is already underway. These measures will help to rebuild confidence in the financial system. In other areas, there is as yet no clear consensus on whether regulatory change is needed or whether other avenues could be considered. The hedge fund sector is one area where the need for further work – starting with an analysis of self-regulatory actions – will be needed.[1]

In global terms, hedge funds have grown fifty-fold in terms of assets under management since 1990 – although they still account for only 5-10% of assets managed by the global fund industry. In recent years, trading by hedge funds has accounted for over 50% of the daily trading volume in equities markets. Hedge funds have also been amongst the leading buyers and sellers of many of the credit derivative and other structured products that have been at the heart of the recent financial crisis. Hedge funds have evolved from being a fringe player to a crucial provider of liquidity and driver of price formation in global financial markets. Hedge fund investment techniques have recently been borrowed by mainstream asset management (130/30 funds or funds of hedge funds). Hedge funds have become increasingly accessible to mass affluent and retail investors in diluted form.

While the benefits of hedge fund activity to the functioning of financial markets have been recognised, questions have been raised about the comparatively limited extent to which hedge fund managers and funds are subject to regulation or direct macro-prudential oversight. Many of these concerns were raised in the recent reports by the European Parliament.[2] Concerns expressed relate in particular to the impact of the activities of highly-leveraged investment vehicles on the stability of the financial system; and to a perceived lack of transparency of hedge funds vis-à-vis regulators and other financial market actors.

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1 The G20 action plan foresees the following approach for hedge funds and other private pools of capital (e.g. private equity funds). 'Private sector bodies that have already developed best practices for private pools of capital and/or hedge funds should bring forward proposals for a set of unified best practices. Finance Ministers should assess the adequacy of these proposals, drawing upon the analysis of regulators, the expanded FSF, and other relevant bodies.'

2 Report of the European Parliament with recommendations to the Commission on hedge funds and private equity (A6-0338/2008) ['Rasmussen' report] and European Parliament report with recommendations to the Commission on transparency of institutional investors (A6-0296-2008) ['Lehne' report].

Some of these concerns have come into sharper focus as hedge funds have, like many other financial actors, been heavily affected by the recent financial crisis. Hedge funds have been affected in the following ways:

– They have been directly exposed to the convulsions in some financial markets. This has led to a sudden marked deterioration in their performance compared to recent track-record, significant losses for their investors, and a few fund failures.

– Hedge funds, which have traditionally relied on relatively high levels of leverage/borrowed funds, are – like many other borrowers – finding it more difficult to obtain leverage to finance their investment policies as their traditional sources of leverage (prime brokers/investment banks) have scaled back lending.

– Hedge funds have also found themselves confronted with the difficulty of managing large-scale withdrawals by investors. This has in many cases forced them to divest assets, further fuelling declining asset prices.

This public consultation will play an important role in identifying and shaping the European response to vulnerabilities emanating from the hedge fund sector. The focus of this consultation exercise is on hedge funds, although some of the issues raised in this paper are not specific to hedge funds. The responses to and conclusions from this consultation will serve as the basis for an appropriate regulatory initiative which the Commission will present before the next European Parliament elections, thus forming part of a wider review of the adjustments needed to the European or international regulatory framework in the aftermath of the crisis. An open dialogue between regulators and all interested parties, including investors and the hedge fund industry, is indispensable if the appropriate conclusions are to be drawn.

This consultation paper sets out five areas on which further information and evidence is sought from all interested parties. The issues are wide-ranging and have implications for all financial market actors, including the financial industry, investors, regulators and the firms in which hedge funds invest.

1. SCOPING THE ISSUES:

One of the first challenges in analysing the issues arising from the activities of hedge funds is to define the entities to which we refer. We are faced with a large diversity of actors within the sector, in particular with respect to their investment strategies. As a common denominator, hedge funds are collective investment vehicles which can generally be distinguished from other types of investment fund by the following characteristics:

- *Focus on delivery of absolute returns* even in the context of declining markets through the use of hedging and flexible investment strategies.
- These investment strategies typically translate into a *relatively high and systematic use of leverage* – through borrowing, short-selling and derivatives positions.
- Traditionally, the hedge fund investor base has been confined to *institutional or other sophisticated investors which have led regulators to exempt hedge funds from many investment protection and disclosure requirements.* However, the extent to which hedge funds are exempt from regulatory requirements differs across countries.

Many of these features are not peculiar to hedge funds. 'Hedge-fund like' trading strategies are replicated elsewhere in the financial system, for example in the proprietary trading activities of investment banks. However, the deployment of these strategies through the vehicle of an investment fund is what distinguishes hedge funds from all other financial actors.

The principal actors in the hedge fund business are (1) the hedge fund manager, (2) the fund itself (which is often legally distinct from the manager), (3) the administrator of the fund (responsible for processing trades and valuing assets) and (4) the prime broker which provides critical support services and liquidity to the fund. Across the main European markets, there is no single pattern to the way that these activities are organised or regulated. In those Member States which are home to hedge fund managers, the hedge fund manager is a regulated entity, reporting to the local supervisor for a variety of purposes. The fund itself may be a regulated onshore vehicle, but more often than not will be domiciled in a third country.[3] The administrator of a European hedge fund will usually be independent of the manager and located in a different European country. Finally, European hedge fund managers compete with other funds and managers from around the world, for the custom of international investors. The form or intensity of the regulation that applies to any part of the hedge fund value chain differs from one country to another. Therefore, the commercial and regulatory geography of the hedge fund industry is complex. Any policy response must take the particularly pronounced international character of these markets into account.

Questions:

(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?

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

2. SYSTEMIC RISKS

Global hedge fund assets under management peaked at around $2 trillion in 2007. The size of hedge fund positions is amplified by the extensive use of leverage. According to the International Monetary Fund, average hedge fund leverage is between 1.4 to 1.7 times capital, although the level for some hedge funds may be much higher depending on their investment strategy.[4] In addition, the assets in which hedge funds invest may embed leverage so that the real exposures of the hedge fund may be 2 or 3 times the value of the fund's equity.[5] Hedge

3 The Cayman Islands and Bermuda are large hedge fund domiciles.
4 Significantly higher levels of leverage have been encountered in large hedge fund failures.
5 "The state of the corporate board", McKinsey Global Survey, 2007.

funds have grown to become significant actors in global financial markets, including in structured credit markets.[6]

Hedge funds have not traditionally been considered to be of systemic relevance. Losses incurred by hedge funds and the risk of their failure are borne directly by investors and their immediate counterparties. For this reason, capital reserves are not part of the regulatory 'tool-box' for hedge funds, or indeed other investment vehicles.

The most direct risk-transmission channel from hedge funds to the wider financial system has been through the potential consequences of hedge fund failure for systemically relevant institutions – notably the prime brokers which have important counterparty exposures to hedge funds. Lending by prime brokers to hedge funds is subject to prudential rules. This 'indirect approach' to the regulation of hedge fund activity appears to have been effective in mitigating risks to the banking system. The well-documented failures of LTCM and Amaranth were absorbed by the financial system without long-term market disruption. However, the impact of the failure of a larger, more leveraged fund, or group of funds, may be greater. In addition, assets recently traded by hedge funds may be less liquid and less easily settled so the consequences of hedge fund failure may be more difficult for the market to unwind than past experiences suggest.

Recent developments have demonstrated that hedge funds may impact wider market dynamics in other ways. By virtue of their volume and the frequency of their trading, hedge funds may pose risks to the stability of the financial system through the pro-cyclical effect of their activities on asset markets. Just as hedge fund trading is argued to have contributed to the inflation of asset price bubbles, they have also been central to the rapid process of deleveraging which has contributed to the recent volatility of asset prices. Faced with redemption requests from investors and tighter credit conditions from prime brokers, hedge funds have been forced to sell assets into already fragile markets. This may have contributed to a downward spiral of deleveraging and declining asset prices, in particular in markets where there has been crowding of positions in similar assets.

It is essential that front-line regulators are in a position to monitor the build-up of risks in this sector, so that they are able to form an accurate and timely judgement on the extent of aggregate leverage and on the crowding of hedge fund trades. The financial crisis has revealed that the level of transparency towards regulators throughout the financial markets has not been sufficiently high to allow timely judgements to be made and corrective action to be taken.

Questions:

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

(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?

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6 According to Bank of America research, hedge funds have sold 31 percent of all CDS protection (approx. USD 18-20 trillion).

(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. MARKET EFFICIENCY AND INTEGRITY

It is commonly held that hedge fund activities contribute to the efficient functioning of financial markets by deepening market liquidity and enhancing the price discovery process. In normal market conditions, rapid trading and the diversity of hedge fund strategies may help to boost market liquidity; and the recourse by many hedge funds to short-selling techniques may help to correct the prices of over-valued securities.

However, recent stressed market conditions have raised a number of concerns about the impact of hedge funds on the efficiency and integrity of financial markets. Some of these concerns have crystallised around the issue of short-selling – which is an investment technique heavily but not exclusively used by hedge funds.[7] Short-selling is generally regarded as a legitimate hedging or trading technique. However, we have recently seen instances where fears that short-selling could drive the stock price of systemically relevant financial institutions to exaggeratedly low levels and thereby undermine their viability. This prompted the introduction of temporary curbs on the practice in many jurisdictions around the world.

In addition, concerns were voiced that short-selling was sometimes being used in conjunction with abusive practices, such as the spreading of false adverse rumours or manipulative actions (such as related trading in credit default swaps). There is a need for a clearer understanding of situations where 'short-selling' could form part of an abusive trading strategy, as well as better monitoring and detection of such practices.[8]

In general, there remains considerable uncertainty as to the extent of short-selling and the purposes for which it is used. In this respect, enhanced transparency of short selling practices should be envisaged as a minimum, without excluding the possibility of more restrictive approaches. However, if such an approach were considered, it would need to be undertaken on a cross-market basis and should not be confined to hedge funds only.

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7 Naked or uncovered short selling involves the sale of an asset that the seller does not own. The Short-seller enters into a promise to deliver an instrument at a fixed price at a future date, while expecting the asset to decline in price in the interim. This will allow the asset to be bought in the market at a lower price when it is needed to settle the short-sale transaction, resulting in a profit for the short-seller. Short-selling may be accompanied by a parallel stock-borrowing transaction. This provides the short-seller with some additional assurance that he/she can source the asset needed to meet its settlement obligation at the agreed date, on the agreed terms.

8 Important work on these issues has recently by launched by IOSCO: "Consults on Regulatory Standards for Funds of Hedge Funds" published in 6 October 2008 and Technical Committee Task Forces to Support G-20 Aims", announced in 25 November 2008.

Questions:

(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?

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

(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?

4. MANAGEMENT OF MICRO-PRUDENTIAL RISKS

Another set of issues relates to the internal processes of hedge funds, in particular the manner in which they manage their own risks, value their asset portfolios and avoid any potential conflicts of interest or other risks to their investors.

Traditionally, regulators have not concerned themselves with overseeing the risk management and asset valuation processes of hedge funds to the same degree as for retail investment funds. The investor base for hedge funds has typically comprised institutional investors and high net worth investors deemed sufficiently savvy to understand the higher risk of capital loss associated with hedge fund investing and whose investment portfolios were sufficiently large to absorb the losses of the occasional hedge fund failure. As long as hedge fund related losses were confined to investors judged capable of investing on a caveat emptor basis, authorities saw no need to police the internal workings of the hedge funds. Furthermore, hedge funds, which have traditionally required investors to lock-up their assets for relatively long time periods, have not faced the same liquidity management pressures as retail funds which allow investors to redeem funds at frequent intervals.

Recent large scale redemption demands by hedge fund investors have demonstrated that hedge funds – and particularly funds of hedge funds – are not immune from liquidity risk. In addition, the rescue or failure of important prime brokers and other market counterparties have underscored that hedge funds are exposed to important counterparty, custodian and settlement risks. Their risk-management processes and back-office administration must keep pace with the increasing demands of a more complex market. Otherwise, investors in hedge funds will be exposed to losses stemming from operational or risk management failures which they cannot assess on the basis of standard industry disclosures.

The Financial Stability Forum has previously called on the hedge fund industry to deliver improvements with respect to risk management processes and valuation techniques. In response, self-regulatory codes have been developed, which detail recommended practice. It is not yet clear whether these have had a material impact on the robustness of the internal processes of hedge funds, particularly in stressed conditions.

Questions:

(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?

5. TRANSPARENCY TOWARDS INVESTORS AND INVESTOR PROTECTION:

Hedge fund investors have traditionally been institutions or wealthy individuals with the capacity to understand and to bear the risks that their investments entail. This investor base has expanded in recent years and now includes pension funds, small and medium sized enterprises, public institutions and retail investors. However, recent study shows that the exposure of European retail investors to hedge funds and funds of hedge funds remains limited.[9]

Regardless of their market standing, all investors require information on the nature and the risks of the investment into which they are entering. The appropriate content and form of this information will vary according to the degree of sophistication of the investor. In the case of public offerings, pre-contractual disclosures are typically highly regulated. When banks and investment firms distribute hedge funds, they should comply with the existing rules concerning the provision of investment services (such as information requirements and, where required, appropriateness or suitability assessment depending on the service provided).

When, as is typically the case, hedge funds are distributed directly to professional investors, disclosure practice is driven largely by contractual arrangements between the funds and their investors. Investors request information to serve as the basis for their due diligence and to ensure compliance with their own investment constraints. In some jurisdictions, certain information obligations have been codified through self-regulatory standards, such as those overseen by the Hedge Fund Standards Board in the United Kingdom.

It has been claimed that hedge funds do not always provide sufficient information on a pre-contractual and ongoing basis to allow investors to assess the risks of their investments. For example, information on investment policies or risk management procedures may be incomplete or infrequently updated.

Questions:

(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

9 "The 'retailisation' of non-harmonised investment funds in the European Union" (ETD/2007/IM/G4/95), PricewaterhouseCoopers, October 2008.

a significant contribution to the transparency of hedge fund activities to their investors?

(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?*

6. CONCLUDING REMARKS:

The European Commission's previous analysis of the risks presented by hedge funds to the European financial and economic system suggested that all significant risks were adequately addressed by a combination of EU legislative measures, national regulation and self-regulatory codes. In many respects, these safeguards have withstood pressures unleashed by the financial turmoil.

However, the intensity of recent market convulsions has triggered dynamics which have exposed some frailties in hedge fund operating models and market organisation. They have revealed that hedge funds may play a pro-cyclical role that might warrant closer prudential oversight.

The Commission expects this consultation exercise to generate informed and evidenced views on the range of issues addressed in this paper. This will permit a better appreciation of the way in which the European policy stance towards hedge funds should evolve.

The Commission believes that the adjustment to the policy stance as regards hedge funds should be part of the overall EU review of the regulatory and supervisory framework in financial markets.

Therefore, the responses to this consultation will serve as the basis for an appropriate regulatory response which the Commission will present before the 2009 European Parliament elections, upon consideration of the report of the High Level Expert Group chaired by Monsieur Jacques de Larosière. Thus that proposal will be part of a coherent and comprehensive policy response to the financial crisis.

The responses to this consultation will also serve as the basis for a fresh and up-to-date European input into the parallel reflections on hedge funds at international level through the G-20 and IOSCO process. This is particularly important in view of the global nature of the hedge fund industry.

In order to feed into the emerging European strategy and international reflections, this consultation must be concluded within a short period of time.

Responses to the consultation are requested by January 31st 2009. Responses can be addressed to **markt-consult-hedge-funds@ec.europa.eu**.

The issues discussed in this document and feedback from this consultation will be discussed at a high-level conference in Brussels in late February 2009.