EACB answer to the public consultation of the European Commission on hedge funds

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General remarks

EACB welcomes the initiative of the European Commission to carry out a comprehensive review of the regulatory framework for hedge funds and shares the view of the necessity of a better regulation and a higher transparency and supervision in this field.

Even if hedge funds are able to improve the market efficiency with their innovative portfolio selection technologies, potentially their activities also imply risks. Said systemic risks can have the following origin:

- Market disturbances: the insolvency of major hedge funds can directly affect banks with which they have a business connection. Another possible consequence could be the loss of confidence of investors in hedge funds;

- Liquidity disturbances: The decrease or even the loss of market liquidity can affect other market players, mainly those that have similar positions as hedge funds.

- Shortcomings of the risk management: Especially in those cases in which the hedge funds strategies require a high leverage.

Nevertheless, EACB is of the opinion that any limitation that could prevent investors from getting access to interesting funds and management strategies that can be valuable for the development of their portfolio management strategy should be avoided.

(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?

Yes, hedge funds do have specific elements that justify a different regulatory approach. Hedge funds build on already existing investment strategies that by combining them are able to create new asset types. Therefore, said distinct features deserve a targeted assessment of their activities.

The focus should be on how to increase the degree of transparency and investor protection (valuation, liquidity, etc.). New regulation should aim at assuring a similar degree of investor protection as any other investment vehicle being marketed within the EU member States – so that investors really understand the risk and potential rewards of the fund – but not at deciding which strategies or assets can or cannot be used.

In order to sharpen a possible definition it might be helpful to outline characteristics of hedge funds:

- Low level of transparency on market exposures / positioning for investors and regulatory authorities.
- High level of discretion on the side of the hedge funds manager.
- Only a lose contractual relationship between investment manager and fund without liability or accountability of the hedge fund manager.
- No registration or public filing of offering memorandum and documents with competent financial authorities.

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

We consider it as important that European policy makers take any required steps for a better protection of European investors. However we would like to highlight that a purely European regulation regarding hedge funds is not sufficient.

The majority of hedge funds is based in tax havens and acts globally. They are only barely regulated in most of the relevant markets. Therefore only an international political coordination on the matter can contribute ultimately to more financial stability.

We would welcome concrete measures in four areas:

- Exchange of information between financial authorities
- Evaluation of data regarding hedge fund risks
- Enhancement of rating methods
- Formulation of a code of conduct

An **exchange of information** between competent financial authorities on a regular basis would be reasonable. They should improve the dialogue between themselves and hedge funds, hedge funds managers and prime brokers in their jurisdiction and share information and experience on the matter with other financial authorities.

Data on potential systemic risks arising from hedge funds activities are already collected on a national level. We would welcome the introduction of an international working group that evaluates whether those data could be **harmonized on a global level**. However this should not lead to stricter supervision and reporting obligations.

In addition we would appreciate if rating agencies could be encouraged to **enhance their rating models** related to hedge funds.

A further important measure would be the development of a **code of conduct for hedge funds** and their managers. Already elaborated proposals (e.g. from the President's Working group or the Hedge Funds Working Group) are steps in the right direction. For the concrete wording of such a code we would appreciate if an international organization – e.g. the IOSCO (depending on FSF deliberations) – would take the lead on the matter. After the elaboration of a code an independent monitoring process should be established and possible breaches against it should be publicly available.

In terms of the protection of the market integrity we would like to point out that there is already a range of regulation on a European level which applies also to hedge funds managers. Further regulatory steps are not necessary on this matter.

One of the main criticisms towards hedge funds is a lack of transparency regarding activities as shareholders of target companies. On this matter we would like to emphasize that the competent policy makers already widened significantly reporting and transparency obligations for purchasing or selling shares of listed companies. The transparency directive additionally allows member states to decide on stricter rules.

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

Already in 1998 the downturn of the hedge fund "Long-Term Capital Management" has proven the systematic 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?

Yes, alternative approaches are necessary. It is certainly necessary that banks as investors are not affected by defaulted hedge funds. In particular, it would be important that they dispose of tools for an appropriate assessment of the incurred risk (see our answer to question 2). This could be done within the context of the ICAAP under Pillar II.

Furthermore, it is also necessary that regulators assess the systemic risk posed by hedge funds themselves, especially by those that by reasons of overall size or weight in a particular company, industry or asset, can affect markets systematically.

(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?

The Financial Stability Forum (FSF) elaborated a set of measures regarding hedge funds following the G8 summit in Heiligendamm in June 2007. The FSF pointed out that the responsibility for a reduction of systemic risks lies on security regulators and market participants:

The security regulators should call on prime brokers to enhance their risk management regarding hedge funds. In addition security regulators should liaise with prime brokers in order to improve their robustness in case of a possible erosion of the liquidity of the market. Regulators should furthermore scrutinize whether a revised set of data on the consolidated position of prime brokers to hedge funds would facilitate the duties of the security regulators.

Prime brokers and investors should take actions for an enhanced market discipline and demand from hedge funds adequate and prompt information on the risks and the value of the portfolios. Hedge funds should develop a Code of Conduct for hedge funds managers.

The international conference planned for the end of February would be a good chance to enforce those elaborated measures.

(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 indication yet that especially lower hedge fund trading has led to less efficient financial markets. Stronger price movements, higher volatility, bid-offer-spreads and lower trading volumes seen in the current markets are more attributable to a general market uncertainty among all market participants than to a specific group like hedge funds.

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

From the perspective of our members a regulation should not target particular investment strategies. Buying and selling assets (whether through cash instruments or the use of derivatives) are the two sides of a market. To restrict only one side must inevitably lead to distortions in the price finding process. We consider short selling as an investment strategy and its impacts should be discussed independently from the discussions on hedge funds, as it is currently happening in consultations of IOSCO and CESR.

(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?

Short selling contributes to the efficient functioning of the financial markets. The ability to sell short enhances information efficiency so that information about the affected company is reflected more rapidly in the price of its shares. Short sales can thus help to correct excessive price increases and the formation of bubbles.

In the course of the financial crisis 2008 security regulators classified short selling especially with shares of financial institutions as dangerous for the stability of the financial markets and restricted and/or forbade short sales. We consider those interventions as acceptable in crisis situations.

The prosecution of abusive market practices like spreading misleading rumors – whether in connection with a long or short market positions – needs to be separated from this discussion.

(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 prove that they can properly value their assets and that they fully understand – and transparently inform of – the risks they take on (especially in terms of their special features such as leverage and liquidity problems as well as credit risk concentration). They should also have enough structure to carry out their processes, including managers, back and middle office operation, audit, administrator, reporting means to investors, markets and regulators.

A possibility could be the inclusion of hedge funds in the UCITS regime, as it is being discussed by the Commission and the Parliament since a fairly long time. The adjudication of the UCITS label to hedge funds including quality standards in relation to the organization, management, information to clients and the procedures in case of conflicts of interest represents an appropriate method in order to achieve the necessary standardization and transparency. However we would like to point out that only funds of hedge funds should be accessible to retail investors – and be included in the UCITS regime – but not single hedge funds.

(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?

Our members consider the received information from hedge funds both on a pre-contractual and ongoing basis as not sufficient. Investor protection should be improved in terms of explaining the special risks embedded in hedge funds, in particular a stress testing of NAV fluctuations and liquidity problems should be offered. The respective parts on the information of investors in the Codes of Conduct of the Hedge Fund Working Group (HFWG) and the President's Working Group (PWG) are a step in the right direction (see answer to question 2).

(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?

As already pointed out in our answer to question 9, single hedge funds should not be accessible to retail investors.

Contact:

The EACB trusts that its comments will be taken into account. For further information or questions on this paper, please contact:

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