

EPFSF Briefing: Hedge Funds

Summary: Hedge funds are increasingly significant participants in European, American, and other developed markets. They contribute to improve trading, price discovery and innovation processes as well as enhance liquidity in many different financial and other assets in both developed and emerging markets.

Hedge funds have brought significant benefits to the financial markets. At the same time their explosive growth has raised concerns amongst supervisors and regulators as to whether increased attention might be required to address issues of systemic risk, investor protection and hedge fund activism in the market for corporate control. Hedge funds, although not subject to product regulation, are like other market participants subject to general conduct of business norms, including market abuse rules.

Background

As there does not exist a common definition for hedge funds these can be described as pooled investment vehicles that traditionally are privately organised, managed by investment professionals, and not widely available to the public. They are extremely diverse, employing many different investment strategies with varying amounts of leverage, liquidity and concentration risk in different asset classes in markets around the globe. Compared to “traditional” investment funds hedge funds are not restricted in their investment strategies and investment universe. Using these leeways hedge funds seek to realize positive absolute returns independent from actual developments on the financial markets instead of outperforming pre-defined benchmarks. The fund of hedge funds (FoF) sector provides further overlay in which the FoF manager will “package” individual hedge funds in the FoF vehicle, providing investors with exposure to multiple managers.

Global assets under management of the hedge fund industry totalled an estimated US\$ 1.6 trillion¹ in the third quarter of 2006 – an increase of nearly 25% since year-end 2005 – while the number of hedge funds increased 6% in 2005 to reach around 9,000. The European market has participated in this growth: hedge funds located in or managed from the European Union numbered around 1,250 in January 2006. They manage estimated assets of more than \$ 325 billion.

The investor base for hedge funds is today much broader and no longer the preserve of the sophisticated or “qualified” investor, such as high net worth individuals, with a good understanding of risk. There is a growing inflow from institutional funds oftentimes with a retail client base: in 2005, 12% of UK pension funds allocated on average 7% of their portfolios to hedge funds, while 13%² of pension funds in Continental Europe and Ireland did so with generally higher portfolio allocations. A recent survey of European pension funds showed that in 2005 some rebalanced their asset allocation towards a higher proportion of equities but, above all, towards alternative assets such as property, commodities and hedge funds.

Market benefits of hedge funds

Many market observers now accept that hedge funds contribute positively to global financial markets. They can provide portfolio diversification for investors since their returns are often less correlated with those of traditional investment funds. Their willingness and ability to take short positions on securities also aid price formation. They contribute to innovation in financial instruments. Hedge funds also improve liquidity in otherwise low liquid market segments, and therefore enhance the efficiency of financial markets. They assist counterparties to reduce or manage their own risks. They often are activist shareholders who are quick to call for necessary business restructuring, improved shareholder value, and better corporate governance. Last but not least they offer investors greater investment choice through introducing a new asset class and are important clients and counterparts for the financial services industry.

¹ Source: Hedge Fund Research Inc.

² JP Morgan Fleming Asset Management, 2005 and Mercer Investment Consulting, May 2006

Regulatory Environment

Given the private origins of hedge funds, the variety of funds, products and strategies, the differing client base involved and the consequent difficulty of defining a “hedge fund” as opposed to a traditional investment fund, it is not surprising that there is no specific regulation governing hedge funds per se. However, this is not to say that hedge funds are not subject to regulation. As with any market participant, they are subject to the general conduct of business norms; they are generally included in the asset management sector under the various UCITS and other EU directives; they are, of course, subject to the market abuse rules; and they are also subject to company law and takeover panel reporting rules when they acquire significant stakes in companies.

Systemic Risk: According to market estimates, while HFs account for only 2% of global securities market value, they play a major role in specific markets and market segments.

Since the failure of Long Term Capital Management in 1998, supervisors have obtained better insight into hedge funds whose strategies entail high leverage and the use of complex financial instruments. The industry itself has increased co-operation to identify areas of possible systemic risk – most notably through the efforts of the Counterparty Risk Management Policy Group (CRMPG). The most recent CRMPG report noted - amongst others - that there is heightened resilience in the financial system, enhanced hedge funds’ risk management, prudential supervisory practices and improved infrastructure in major markets.

Counterparties and service providers of hedge funds have continuously enhanced their risk management procedures over the recent years allowing for a better assessment and controlling of their businesses’ risk exposure to hedge funds.

The Deutsche Bundesbank brought into discussion the idea to make hedge funds subject to analyses of rating agencies in order to make available independent and acknowledged judgements of the hedge funds’ financial positions. While not explicitly commenting on credit quality or performance of the investment portfolio, such rating agency analysis offers hedge funds a credible way to enhance transparency and accountability towards their counterparties. However, given the dynamics of the sector and the management time involved, not all hedge funds may be ready to go through a rating process yet.

Both the US Federal Reserve and the UK FSA (jurisdictions where the bulk of hedge fund activity is based) believe that there is no systemic or serious market disruption risk implied by global hedge funds, although supervisors should focus on larger funds with positions capable of moving markets.

Investor Protection: There is increasing pressure in Europe and elsewhere for the “retailisation” of hedge funds in order to allow more retail access through hedge fund instruments. Generally, exposure by retail investors to hedge fund strategies is by way of lower risk products such as well diversified notes, often including a capital return guarantee, marketed by banks to their customers or fund of funds instruments which again provide appropriate diversification.

Currently, some but not all Member States impose a minimum subscription for purchasing units in hedge funds, or qualitative requirements upon investors in the fund.

The Alternative Investments Experts Group (AIEG) appointed by the EU Commission to analyze the difficulties in doing business faced by alternative investment funds has pointed out that at the European level no product regulation on hedge funds is necessary. Adequate investor protection can be achieved through existing regulation of managers, intermediaries, and institutions which administer and execute sales contracts with end investors. A minimum threshold level of €50,000 to prevent access for investors not suited for this type of investment should suffice to allow cross-border marketing of hedge funds to institutional or qualified investors. In addition, they recommended the removal of restrictions on investing in hedge funds imposed on some institutional investors such as insurance companies, pension funds and banks. Such a package would not stifle innovation nor push the management of hedge funds offshore. The EC has not so far shown any public dissent from this position.

Hedge Funds and Corporate Governance

Hedge funds have been accused of short-termism or taking opportunistic arbitrage positions in companies whose managements are then subject to aggressive pressures. But hedge funds are increasingly recognised to be a necessary corrective to management complacency by fostering managements to perform and to deliver on shareholder value commitments.

Many companies are less suspicious of hedge fund managers than they were some years ago but they do distinguish between “thought leaders” and “day traders” with the former bringing more to the relationship. Corporate managers are learning to value and exploit the feedback and strategic advice they receive from hedge fund managers; they rate the business acumen of hedge fund managers more highly than the classic (and often passive) institutional “long-only” investor.

Some companies can be frustrated by their inability to identify hedge fund managers as shareholders since shareholding patterns are not always clear. However, significant shareholders will generally make corporate managements aware of their interest and seek to ensure that management understands and addresses their concerns. In Europe and the US reporting requirements exist that require any holder of a certain percentage shareholding to report its interest in the company’s shares.

Service Providers for Hedge Funds

Typical services provided for hedge funds include prime brokerage, fund administration and custody.

Prime brokerage: Prime brokers provide a range of customised services to hedge funds. Current services include handling trade execution, clearing and settlement, providing financing and technology services, risk management and operational support facilities, securities lending, and making introductions to sources of capital.

Fund Administration: Some hedge funds conduct administration internally while others choose to outsource certain functions such as their accounting, investor services, risk analysis or performance measurement functions to third party administrators. Some outsourcers offer independent pricing of a fund’s portfolio of securities.

Custody: Hedge fund assets are generally held with a custodian, including cash in the fund as well as the actual securities. Custodians may also control flow of capital to meet margin calls.

Cross-border marketing and distribution of hedge funds

The issue of the cross-border marketing and distribution of hedge funds is a significant issue for the EU. Since UCITS are subject to a high degree of product regulation in the form of controls over structure, investment and borrowing capacity, they are suitable for cross-border distribution to retail clients. Clearly hedge funds are not intended to be subject to the same degree of product regulation intended for large scale retail marketing.

A harmonised private placement regime could provide a way to sell hedge funds on a cross-border basis to institutions and certain qualified investors without hampering investor protection.

Conclusion

As hedge fund activity increases in significance, growing public debate about their role can be expected. Indeed, better information can increase public understanding on their contribution to liquidity, price discovery, financial innovation and efficient markets. Supervisors and regulators are wise to continue their regular dialogue with the industry and associated market intermediaries on possible systemic risks, especially with regard to large exposures and the use of complex financial instruments. Although not subject to specific product regulation, hedge funds are bound by the normal rules governing conduct of business and market abuse. Shareholder activism by hedge funds, although at times controversial, can help promote efficient industrial restructuring thus supporting growth and jobs, increase shareholder value and improve corporate governance.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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