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- FEEDBACK STATEMENT -

SUMMARY OF RESPONSES TO HEDGE FUND CONSULTATION PAPER

The financial crisis has led to renewed debate about the impact of hedge funds on the functioning of financial markets. The de Larosière High Level Group has summarised the situation as follows: 'Concerning hedge funds, the Group considers they did not play a major role in the emergence of the crisis. Their role has largely been limited to a transmission function, notably through massive selling of shares and short-selling transactions. We should also recognise that in the EU, unlike the US, the great bulk of hedge fund managers are registered and subject to information requirements. This is the case in particular in the UK, where all hedge funds managers are subject to registration and regulation, as all fund managers are, and where the largest 30 are subject to direct information requirements often obtained on a global basis as well as to indirect monitoring via the banks and prime brokers.'¹

Notwithstanding this, there is a desire to provide a common regulatory and supervisory framework to underpin the oversight of, inter alia, hedge funds. The European Parliament has clearly expressed this view in its reports of September 2008 (Rasmussen & Lehne reports). The move towards closer regulatory engagement with hedge funds has also been evident in international discussions concerning the regulatory response to the financial crisis. The G20 (November 2008) summit issued a call to extend regulatory oversight to all financial markets, institutions and products – including private pools of capital. This has been followed quickly by

the creation of an IOSCO task force on hedge funds.

It was against this backdrop that the Commission published a consultation paper on hedge funds on December 18th 2008. This consultation document sought views and evidence on a range of hedge fund related issues so as to inform the preparation of an appropriate regulatory initiative. The issues on which the Commission invited views included:

- **Systemic risks.** The consultation asked whether existing systems of macro-prudential oversight were sufficient to allow regulators to monitor and react to risks originating in the hedge fund sector and subsequently transmitted to the wider market through counterparties, including prime brokers, and through the impact on asset prices.
- **Market integrity and efficiency.** The consultation asked whether and under what circumstances the activities of hedge funds posed a threat to the efficiency and integrity of financial markets.
- **Risk management.** The consultation asked whether public authorities should concern themselves more with the way in which hedge funds manage the risks to which they and their investors are exposed, value their asset portfolios and manage any potential conflicts of interest.
- **Transparency towards investors and investor protection.** The consultation invited views on whether hedge fund investors are adequately protected and receive the information required for sound investment decisions.

¹ Point 86, p. 24, Report of High-level Group on financial supervision in the EU, published 25.02.09.

The deadline for responses to this consultation paper was January 31st 2009. One hundred and four answers to the consultation have been received: 71 % from private sector organisations and representative bodies, 8% from citizens and 21% from public authorities.

The principal messages and issues highlighted by the respondents are:

- *Hedge funds are complex products best reserved for sophisticated investors;*
- *Hedge funds represent a very heterogeneous class of asset and investment strategies so there are inherent difficulties to be overcome in designing an operational regulatory response that avoids a 'one size fits all' solution. Most respondents believed that an international or global response would be superior to an EU response. However, a small majority of respondents believe that it is nevertheless appropriate to come forward with EU level action;*
- *A considerable number of respondents see concerns ranging from the need for more effective monitoring of hedge fund impacts on financial stability and market efficiency, through risk management systems, organisational arrangements and use of particular investment techniques (e.g. short selling);*
- *Much comment centred on the impact of hedge funds on financial stability. Currently, the potential systemic impact of hedge funds is addressed primarily through oversight of systemically important hedge fund counterparties (investment banks, prime brokers). This approach was widely seen as important – but only part of the solution. Various respondents observed that supervision of hedge fund counterparties does not protect financial markets from cyclical impacts of herding behaviour by hedge funds, hedge fund trading concentrations in particular market segments and deleveraging. Recent developments have*

revealed the capacity for hedge funds to impact overall market functioning through the market channel, i.e. through impacts on market prices and liquidity. 62% of respondents (to this question) believe that supervisors and macro-prudential authorities should be provided with more information on hedge funds to monitor the systemic effect their activities may have on EU/global markets.

The issues raised by the consultation were discussed at a high-level conference in Brussels on 27th February 2009.² Those discussions and responses to the consultation will contribute to the preparation of a regulatory proposal on hedge funds and private equity funds which the Commission will present before the end of April 2009.

Responses to this consultation will also serve as the basis for European input into the parallel reflections on hedge funds at international level by the G20.

² The conference proceedings are published on Commission web-site. http://ec.europa.eu/internal_market/investment/index_en.htm.

I. OVERVIEW OF RESPONSES TO THE CONSULTATION

The consultation was launched on 18th December 2008 and closed on 31st January 2009. Responses were invited from all interested parties on the questions relating to the activities of hedge funds, their impact on financial markets, and their interactions with investors and other market participants.

One hundred and four answers to the consultation were received from a wide range of organisations and professional representatives, citizens and national and European public authorities. Figure 1 provides a more detailed presentation of the status of responses received broken-down into the following categories: fund administrators, asset managers, asset manager associations, banking associations, trade unions and trade union groupings, consultants, insurance companies, insurance associations, investor associations, lawyers, pension fund associations, prime brokers, professional associations, and stock exchanges. Responses were received from a large number of EU Member States (15) and 4 non-Member States (figure 2).

Figure 1:

Answers from Organisations - by type

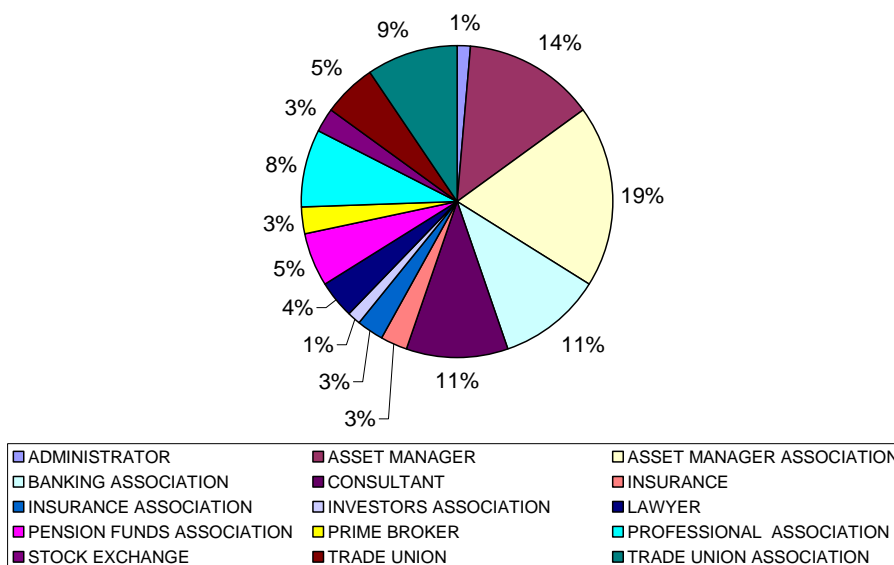
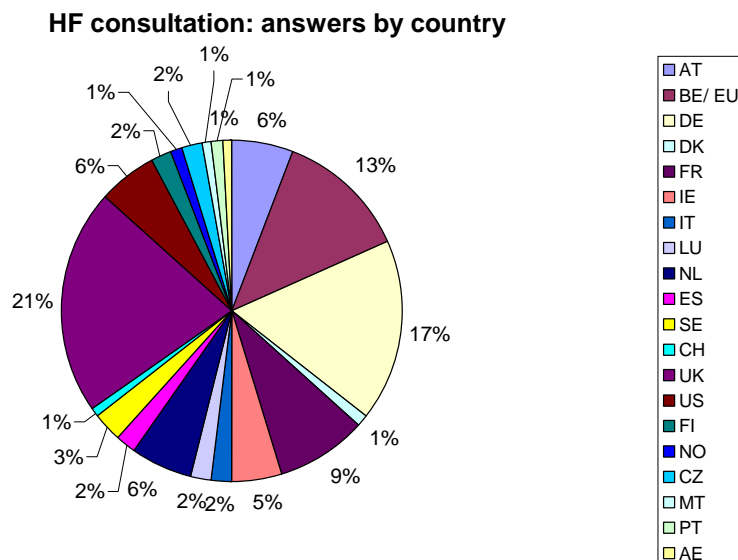


Figure 2:



For the purposes of this feedback statement, answers from respondents have been classified in four sub-groups:

- (1) **Public authorities:** 22 public authorities responded to the consultation. This includes market regulators, prudential supervisors, ministries of finance, Member States' parliamentary groups or individual MEPs, European parliamentary groups and the European Central Bank (Eurosysteem). Some Member States' public authorities have provided a single collective answer.
- (2) **Citizens:** 8 answers from this group comprise contributions from citizens, authors, researchers or research centres or universities.
- (3) **Asset management and financial sector organisations:** 51 answers from this group representing fund administrators, asset managers and their associations, prime broker and banking associations, consultants, lawyers, and other professional associations (such as associations of lenders or derivatives practitioners).
- (4) **Other stakeholders** comprising investor representative bodies (both institutional and retail), labour and listed company representatives (23 answers): organisations such as pension funds and their associations, insurance companies and their associations, investors and their associations, trade union and trade union associations, one consultant and an issuers' association.

2. DETAILED ANALYSIS OF RESPONSES:

The feedback statement presents a broad summary of responses to each of the eleven questions raised in the consultation paper. The tables provide a quick overview of the balance of respondent opinions. These opinions have been categorized into 'yes/no' categories of answers wherever possible. Some respondents have also provided qualitative commentary to supplement or nuance their 'yes /no' answers. In this case, the explanations have been grouped under a number of sub-headings ("*For one or more of the following reasons:*") to enable a more detailed analysis of the respondents' views.

Please note that some respondents have sometimes expressed more than one opinion in answer to a question. Therefore the cumulative total of answers to a question may sometimes exceed 100% of answers received.

QUESTION 1

Are the above considerations³ 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?

Opinions expressed:	Number of opinions expressed on question n°1	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
Yes , these criteria are sufficient	5	5%	1	0	4	1	3
No , these criteria are not sufficient because the hedge funds class of asset is too heterogeneous	82	79%	22	1	59	45	14
<i>Additional detailed views :</i>							
▪ <i>Criteria identified also apply to other entities which are not considered as hedge funds</i>	22	21%	3	0	19	18	1
▪ <i>Other criteria are relevant</i>	45	43%	14	1	30	24	6
▪ <i>Hedge funds are not "Unregulated". This criteria is not relevant</i>	7	7%	2	0	5	5	0
▪ <i>Hedge funds are not necessarily highly leveraged. This criteria is not relevant</i>	15	14%	4	0	11	11	0

³ For information, criteria identified in the consultation paper were: Hedge funds focus on delivery of absolute returns; Hedge funds have a relatively high and systematic use of leverage; Hedge funds are confined to institutional or other sophisticated investors; Hedge funds are exempt from direct regulatory requirements.

A majority of respondents, including most regulators and organisations from the financial industry, did not consider the criteria identified in the consultation paper as sufficient to distinguish hedge funds from other actors in financial markets:

- (1) The criteria identified in the consultation paper also apply to other entities which are not 'hedge funds', such as (retail) collective investment schemes (130/30, market-neutral and long/short mutual funds). Proprietary trading desks of investment banks *or* institutions (SPV) should also be taken into account when supervising leverage. These entities engage in similar behaviours and give rise to the same risk for underlying investors and financial system;
- (2) Other criteria should also be taken into consideration in defining hedge funds, such as structured performance fees, use of 'alternative strategies', engagement in 'short selling activities', 'Absolute return', use of specific liquidity & redemption rights, etc... It is worth recalling that hedge fund managers also use a wide range of legal structures (collective investment schemes, managed account, feeder/master structures etc.);
- (3) Leverage criteria were seen as not necessarily the most relevant criteria. Some respondents perceived hedge funds as being highly leveraged entities. However, some respondents have provided data showing that the average leverage of hedge funds lies in a range of 1.3-1.8 times capital. They observe that this leverage is significantly less than that witnessed in some investment banks. However, it is difficult to be precise about the level of leverage used by hedge funds. Figures supplied by respondents do not include leverage embedded in financial instruments;
- (4) Some respondents contest the perception of hedge funds as unregulated. Even at EU level, aspects of hedge fund business and hedge funds themselves are subject to MiFID, the Transparency Obligations Directive and the Market Abuse Directive. When they become members of trading systems (Regulated Markets or Multilateral Trading Facilities) they are also subject to the rules of that platform including all relevant transaction reporting rules
- (5) Hedge funds do not form a homogeneous group. A large majority of participants consider that the hedge fund industry is fast moving. A rigid definition of the "Hedge fund" class of asset would therefore become quickly obsolete.

QUESTION 2

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

Opinions expressed:	Number of opinions expressed on question n°2	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
No , a 'pure' EU action won't be effective.	71	68%	17	2	52	39	13
<i>For one or more of the following reasons :</i>							
▪ <i>EU action in isolation will have adverse effects, and/or</i>	43	41%	13	1	29	23	6
▪ <i>International work (IOSCO, G20) should be taken into consideration</i>	46	44%	9	1	36	26	10
Yes , EU should act	53	51%	14	3	36	22	14
<i>For one or more of the following reasons :</i>							
▪ <i>EU should take the leadership, and /or</i>	19	18%	6	0	13	7	6
▪ <i>EU action will enhance international cooperation</i>	15	14%	7	2	6	5	1

A majority of respondents are not convinced that a "purely" European response is likely to be successful. They feel that it may even have adverse effects on the European asset management industry, exposing it to regulatory arbitrage. Initiatives taken by the G20, FSF and IOSCO should also be integrated into ongoing reflections at the European level. A heavy-handed EU response which would not be matched by action elsewhere could simply drive business away and reduce the competitiveness of the EU asset management industry. Given the interconnectedness of global financial markets and the international dimension of hedge funds, any effective answer must be taken at international/global level.

However, the argument that only globally-harmonized regulation works is regarded by other respondents as too simplistic. Over 50% of respondents insist that superiority of international action must not be an excuse for European passivity. Europe is home to a major alternative investment management industry and represents a substantial client base for this industry. It is perceived as a big player in the world economy and offers a vast market for all financial actors including hedge funds. Therefore, many respondents believe that Europe can play an instrumental role in shaping a global regulatory regime for hedge funds through the creation of a "European label". An EU framework could serve as a reference for global regulation of alternative investment management activity. It would help to enhance the attractiveness of the European asset management industry and to foster the spread of standards of best practice. It could also ensure the effectiveness and competitiveness of the single financial market. Some respondents call on the European Commission to establish an adequate and proportionate EU framework. European Single Market for hedge funds would abolish regulatory fragmentation and strengthen Europe's position in negotiations of international

standards. Some respondents perceive a European initiative as a first step towards international consensus on hedge fund regulation.

QUESTION 3

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

Opinions expressed:	Number of opinions expressed on question n°3	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
Yes , recent experience requires a reassessment of the systemic relevant of hedge funds.	35	34%	8	2	25	16	9
<ul style="list-style-type: none"> ▪ <i>But systemic relevance should also be reassessed for all other leveraged market participants.</i> 	23	22%	7	1	15	13	2
No , reassessment is not necessary	31	30%	9	0	22	17	5

Respondents generally acknowledge that hedge fund activities are an integral and valued part of the financial market due to their contribution to market liquidity and market efficiency. A number of industry and public sector respondents feel that there is insufficient empirical evidence to support the view that hedge funds have a particular systemic relevance. However, a slightly larger number of respondents consider that the recent financial crisis has raised new questions about the effects of hedge fund activity, in times of general market distress which call for consideration. In support of this view, these respondents argue that the process of hedge fund deleveraging has added to downward pressure on already falling asset prices in recent months and caused distress to other market participants. Hedge funds may constitute a source of counterparty risk to core financial institutions and the broader financial system as a consequence of sudden and large scale liquidation of hedge fund positions.

Hence, for most respondents the analysis of the systemic risks of hedge funds should focus more on leverage. This work should not focus on hedge funds exclusively, but also on the banking sector and other market participants making extensive use of leverage.

In assessing possible stability impacts, this perspective should take account of assets under management, number of counterparties, level of leverage, and volume of trading.

QUESTION 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?

Opinions expressed:	Number of opinions expressed on question n°4	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
Yes , indirect regulation insulates the banking system from the risk	51	49%	13	0	38	31	7
But, No it also can be improved	46	44%	10	2	34	20	14
<ul style="list-style-type: none"> ▪ <i>Prime brokerage regulation needs to be reviewed.</i> 	28	27%	8	0	20	17	3
<ul style="list-style-type: none"> ▪ <i>Indirect prudential regulation is insufficient to isolate financial system from hedge funds' failure. Additional direct prudential requirement (such as a minimum capital requirement for the asset manager) should apply.</i> 	26	25%	7	2	17	4	13

To date, regulatory attention has been focussed on ensuring that hedge fund bankruptcy does not jeopardise the viability of systemically relevant credit institutions. A significant number of respondents expressed the view that the banking industry seems sufficiently well capitalized to withstand a hedge fund failure. A number of respondents, including public authorities, noted that some hedge funds have been liquidated without destabilizing the banking system.

Respondents feel that prime brokers are subject to strict prudential requirements and have their own risk management tools to protect themselves from counterparty risks. Banks are required to make robust assessments of credit risk and to set aside sufficient capital to absorb reasonably foreseeable counterparty losses. In the view of many respondents, bank risk assessment systems have recently undergone severe stress test and so far, they have proved robust with respect to counterparty risks. However, some respondents also perceive that this remains only a preliminary assessment, based on the initial phases of the crisis. Since credit, counterparty and market risks can materialize quickly, some respondents believe that it may be necessary to further strengthen the prime broker management of hedge fund related risk in order to limit the potential for failure of a very large fund to trigger a systemic impact.

Some respondents expressed concerns regarding the need for more specific and targeted regulatory requirements for prime brokerage business. Concerns related to practices such as re-use by prime brokers of hedge fund collateral, and sometimes the assets of the fund they hold in custody. Other respondents also pointed to the conflicts of interest faced by prime brokers when dealing with hedge funds. Prime brokers may not have the incentives to impose constraints on their exposure to hedge funds given that hedge

funds contribute substantially to the revenues of prime brokers. The effectiveness of indirect (prime broker) regulation may also be limited by the fact that most large hedge funds use multiple prime brokers. Consequently no single broker has all the information necessary to assess creditworthiness and soundness of its hedge fund client. A similar problem derives from the fact that banks conduct stress-testing of exposures with individual hedge funds. However, this stress-testing does not sufficiently take account of the fact that many hedge funds implement similar or highly correlated investment strategies. These respondents therefore conclude that the 'indirect' regulation approach is inherently limited in its effectiveness. It does not sufficiently protect the financial system, since it does not take into account the fact that different hedge funds sometimes imitate each other's strategies and can generally be affected by common market developments.

Some respondents have also expressed their concern that the prime broker's prudential requirements only mitigate risk transmitted via the banking system. This neglects the potential impact of the collective impact of hedge funds on market conditions. Reference was made to the fact that hedge funds account for 50% of trading on financial markets and can play a determining role in price formation. The indirect prudential approach needs to be strengthened and be supplemented by direct surveillance measures to take account of these wider market effects. Some respondents suggested that minimum capital reserves should be part of the regulatory "tool-box".

QUESTION 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?

Opinions expressed:	Number of opinions expressed on question n°5	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
Yes , supervisors do have enough information to monitor effectively exposures	19	18%	4	0	15	13	2
No , supervisors do not have enough information to monitor effectively exposures	64	62%	18	3	43	26	17
<i>Additional comment:</i> ▪ <i>Even with the information, supervisors may not have sufficient tools to adequately monitor the risk</i>	11	11%	5	0	6	4	2

Although some prudential reporting to prudential supervisors is currently required⁴, a large majority of respondents, including most public authorities, financial organisations and investors, feel that supervisors do not have enough information to monitor hedge fund trading activities. To that extent, transparency and disclosure by hedge funds to the supervisory authorities could be improved and harmonized. A single, global registration procedure for hedge funds and their managers is proposed by some respondents as a starting point for improved transparency towards authorities. Hedge funds could also be required to deliver periodic regulatory reports of appropriate information on, for example, size, investment style, exposures, leverage and performance. It is suggested that the information collection process could involve hedge fund managers as well as prime brokers, the valuator, the clearing broker or other central counterparties. Some respondents also feel that prudential authorities may not be sufficiently equipped to monitor effectively exposures of the core financial system to hedge funds, or the contribution of hedge funds to asset price movements.

QUESTION 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? (...)

Opinions expressed:	Number of opinions expressed on question n°6	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
No , the reduction of the hedge funds activity had a negative impact on the markets.	18	17%	5	2	11	3	8
Yes , the reduction of the hedge funds activity has affected trading efficiency.	59	57%	15	1	43	33	10

Most respondents, including most public authorities, believe that markets function less efficiently since hedge funds have scaled back their trading. Against this, many respondents believed that 'forced selling' by hedge funds, triggered by a swift tightening of credit conditions by prime brokers and redemption requests from investors, has tended to amplify downward pressure on the price of assets. This outcome could be exacerbated when different hedge funds are pursuing the same or correlated strategies.

Most financial organisations argue that hedge funds were not the immediate cause of the current financial crisis. They observe that all market participants facing liquidity pressures have been going through the process of deleveraging. For most respondents (public authorities, organisation, investors, pension funds), there is no clear evidence that hedge fund activity impairs markets. The market is perceived to have suffered from

⁴ Regulation (EC) No 958/2007 of the European Central Bank (ECB) of 27 July 2007 concerning statistics on the assets and liabilities of investment funds (ECB/2007/8), all investment funds including hedge funds in the European Union have to notify important information to the National Central Banks (NCB) as of December 2008.

the decline in hedge fund trading, because hedge funds have not been able to act as liquidity providers to the same extent.

European equity market trading volume (measured in number of shares traded) has decreased substantially during the fourth quarter of 2008. This reduction has continued in early 2009; as a result of this reduced trading and liquidity, markets are less able to absorb buying and selling pressure. There is anecdotal evidence showing that primary liquidity at the touch (i.e. the amount of shares available at the best bid and offer) in European financial stocks has decreased since the short selling restrictions were introduced and average spreads (i.e. the difference between best bid and offer) have increased.

QUESTIONS 7 & 8

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

Are there circumstances in which short-selling can threaten the integrity or stability of financial markets?

Opinions expressed:	Number of opinions expressed on question n°7	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
No , short selling is normal market tool under normal market situation.	59	57%	12	0	47	33	14

57% of all respondents to the consultation generally expressed broad support for short selling as a legitimate investment technique under normal market conditions. Many respondents regard it as being generally beneficial to the efficient operation of the market. 17 respondents believe that there is no evidence that short selling has distorted prices against just 3 expressing the view that short selling can distort prices.

Opinions expressed:	Number of opinions expressed on question n°7	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
No , there are no situations where short selling should be restricted: short selling bans had negative impact on the market.	9	9%	0	0	9	8	1
Yes , there are situations where short a selling ban may be warranted under exceptional circumstances.	15	14%	8	0	7	3	4
Yes , there are situations where a short selling ban may be warranted: when short selling transactions can be used as part of an abusive strategy	48	46%	10	0	38	24	14
Yes , short selling should be restricted; short selling positions should be disclosed.	8	8%	1	0	7	6	1
Yes , short selling should be restricted; all short selling transactions should be regulated or limited	8	8%	0	2	6	2	4
Naked short selling should be regulated or limited.	15	14%	5	1	9	7	2

However, a large number of respondents consider that there are a range of circumstances in which short selling restrictions could be justified. This compares to just 9 respondents who believe that restrictions would never be justified.

46% of respondents to the consultation consider that short selling could potentially be used as a part of an abusive strategy. Respondents argued that where this is the case, the focus of regulatory attention should be on the abuse, not on short-selling itself. 15 respondents observed that short-selling may also be problematic in the midst of a loss in market confidence. For example, some respondents mentioned that in a context of a credit crisis where some entities face liquidity challenges, but are otherwise solvent, a decrease in their share price induced by short-selling may lead to further credit tightening for these entities. In a worst case scenario this could result in bankruptcy. When such entities are systemically relevant, there may be a case for shielding them from short selling, leading to further downward pressure on price and erosion of confidence.

15 respondents were of the view that naked short selling is a practice that could be detrimental to market integrity and efficiency. It was suggested that this issue should be addressed through appropriate regulation of clearing and settlement.

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?

Opinions expressed:	Number of opinions expressed on question n°8	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
No , short selling is not a HF specific issue	40	38%	12	0	28	24	4

Those who answered this question took the view that short selling is used by a wide range of market participants – and that therefore it made little sense to address the use of this technique by hedge funds in isolation.

A number of respondents noted that overnight introduction of short-selling restrictions created significant operations and compliance problems for market participants. This was especially the case as actions across different jurisdictions were not coordinated. Some respondents called for a unified, global regime for short selling; the IOSCO task force on short selling was referred to as a promising development in this respect.

QUESTION 9

Should the internal processes of hedge funds be improved, particularly with respect to risk management?

Opinions expressed:	Number of opinions expressed on question n°8	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
Yes, risk management practices need to be improved	39	38%	13	1	25	17	8
<i>Improvements can be achieved:</i>							
<ul style="list-style-type: none"> ▪ <i>through codes of conduct, and/ or</i> 	19	18%	4	0	15	12	3
<ul style="list-style-type: none"> ▪ <i>through additional direct regulatory initiatives</i> 	29	28%	8	0	21	10	11
Risk management can be improved in one or more of the following ways :							
<ul style="list-style-type: none"> ▪ <i>Measurement & portfolio risk management</i> 	15	14%	3	0	12	10	2
<ul style="list-style-type: none"> ▪ <i>Liquidity risk management should be clearly disclosed and explained to investors</i> 	5	5%	3	0	2	2	0
<ul style="list-style-type: none"> ▪ <i>There is a strong need for hedge fund corporate governance regulation</i> 	37	36%	12	2	23	21	2
<ul style="list-style-type: none"> ▪ <i>There is a strong need for hedge fund valuation regulation</i> 	30	29%	6	2	22	21	1
<ul style="list-style-type: none"> ▪ <i>Voting policy of the fund should be disclosed and explained</i> 	5	5%	3	0	2	0	2

There was considerable discussion relating to risk management by hedge funds. Most respondents saw the need for enhancing risk management standards employed by hedge funds. Respondents differed as to whether this could best be achieved through self-regulatory codes of conduct or statutory regulation.

A minority of respondents (19 out of 48) answering this question believe that best practice initiatives, led by market participants, are viewed as a good starting-point for effective regulation.

29 (out of 48) respondents believe that there is a need for some regulatory intervention in respect of hedge fund risk management. In support of this it is argued that experience with self-regulatory codes has raised questions relating to compliance and enforcement which undermine their effectiveness. The existence of these codes has not been sufficient to prevent the emergence of concerns relating to this industry. Indirect supervision (through prime brokers) cannot fully substitute for the required direct regulation and

supervision of hedge fund – and that this regulation should extend to some aspects of hedge fund risk management.

Respondents also provided many suggestions as to how hedge fund risk management could be improved. Some respondents underlined that some hedge funds already implement high standards and processes of risk management. However, a number of respondents remain concerned that there has been excessive reliance on theoretical models for assessing risk. Other respondents consider that initiatives on hedge fund risk management should be directed at the internal governance and organisation of hedge funds. Managers should be required to have adequate resources to support their trading strategies and to demonstrate that they have the appropriate risk management systems and reporting mechanisms.

Responses highlight concerns relating to the risk management process. Respondents call for more transparent and independent valuation controls, liquidity management and corporate governance. Separation of functions is viewed as a way to reduce operational risk and the possibility of fraud, and misappropriation of assets. Thus valuator, administrator, auditors and custodian functions should be separated in order to avoid possible conflicts of interest. In addition, some respondents insist that the assets of the fund should be segregated from those of the prime broker. If not, the interests of the former are exposed to the risk of the bankruptcy of the latter.

QUESTION 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?

Opinions expressed:	Number of opinions expressed on question n°10	% over the number of total contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
Yes , investors received sufficient information	32	31%	5	0	27	21	6
No	37	36%	15	0	22	16	6

A significant proportion of the respondents from industry organisations believe that the hedge fund business is responsive to investor needs. If an investor is not satisfied, he/she should not invest. The client/investor remains responsible for its decision and should undertake its own due diligence. Hedge funds were originally targeted towards institutional investors able to assess complex risk profiles and absorb occasional large losses.

However, a majority of respondents underline that the level and the quality of information available to investors often depends on the targeted investors and is quite unbalanced. Some report deficiencies in the information provided which are either incomplete or not available on an on-going basis. Most information transparency

concerns relate to transparency of the fund liquidity management⁵, redemption policy and on the equal treatment of shareholders (e.g. side letter practice).

QUESTION 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?

Opinions expressed:	Number of opinions expressed on question n°11	% over the total number of contributions received to the	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
Yes , hedge fund should be accessible to retail investors	33	32%	6	0	27	23	4
▪ <i>but with strong regulatory safeguards</i>	27	26%	3	0	24	21	3
No	40	38%	12	2	26	15	11

Most respondents do not view retail investor access to hedge fund exposures as a positive development. Several respondents also expressed some concerns about exposure of pension funds and individuals' investors to hedge funds – given that the assets of individual pension-holders or retail investors are at stake.

Those respondents in favour of access to retail investors recognise that any such access should be accompanied by strong regulatory safeguards.

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⁵ e.g. disclosing information on the proportion of the portfolio invested in non-marketable securities and hard-to-value assets