

# EUROPEAN COMMISSION CONFERENCE ON PRIVATE EQUITY AND HEDGE FUNDS

## Panel 2: Management of Micro-Prudential Risks & Transparency towards Investors

27 FEBRUARY 2009

Noël Amenc  
Jean-René Giraud

EDHEC Risk and Asset Management Research Centre

[noel.amenc@edhec-risk.com](mailto:noel.amenc@edhec-risk.com)  
[jrg@edhec-risk.com](mailto:jrg@edhec-risk.com)  
[www.edhec-risk.com](http://www.edhec-risk.com)

# Agenda

- The failure of external risk control constraints
- EDHEC Hedge Fund Reporting Survey 2008
- Going forward

# The failure of external risk control constraints

- So far, regulators have taken the route of imposing indirect controls through:
  - Ruling the investor's side (e.g., FoHF constraints on their liquidity )
  - Imposing strict access to market through intermediaries (prime brokerage)
  - Promoting independent valuation
- Those rules, when badly drafted, or not verifiable, have very often led to increased moral hazard and adverse selection.

# The failure of external risk control constraints

- For example, funds of hedge funds on which liquidity constraints have been imposed are the ones that increase the problem because of imposed redemption conditions while they invest in less liquid assets.
- By creating a false sense of liquidity through the implementation of liquidity rules that have proven inapplicable and inefficient, the regulator has led final investors to invest in hedge funds in poor conditions.

# The failure of external risk control constraints

- More generally, open-end funds investing in assets with limited liquidity contribute to a false sense of liquidity, often misleading to investors. The recent use of “gates” reflects the failure of the idea that liquidity can be organized by the regulator.
- Similarly, funds promote the use of independent administrators for the valuation of assets, valuations that have proven unsustainable in difficult market conditions.

# The failure of external risk control constraints

- Serious doubt has been cast on the idea that imposing regulated structures will control hedge fund operations and guarantee their assets.
- “Indirect” hedge fund regulation did not survive the liquidation of a prime broker as significant as Lehman; had Bear Stearns not been bailed out by JP Morgan and the Fed, one of the largest counterparties of hedge funds and funds of hedge funds would simply have gone bankrupt.

# The failure of external risk control constraints

- Because the regulator is rarely able to prevent all risks through systematic control of industry practices, it seems that a structure whereby control is mutually organized throughout the industry itself is highly desirable:
  - Reinforcement of the responsibility of the administrator/custodian with regard to pricing the financial instruments of the funds (obligation of result with associated financial responsibility)
  - Responsibility of the auditors with regard not only to the accounting schemes but also to the actual published NAVs
  - Increased transparency on the nature of the risks incurred by underlying investments (including liquidity)

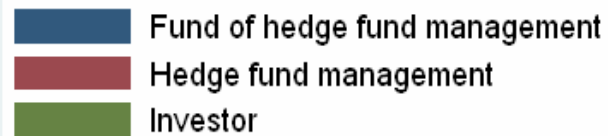
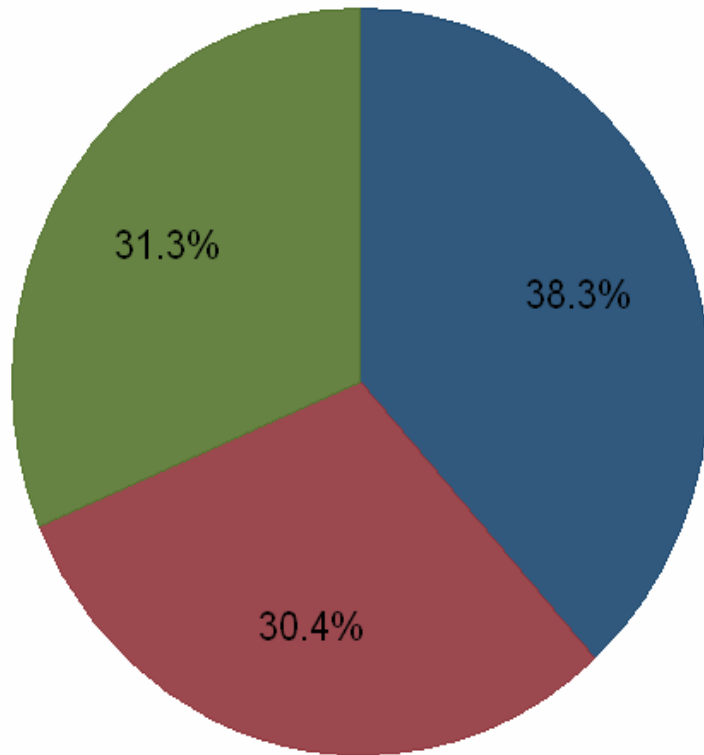
# The failure of external risk control constraints

- We consider this structure more applicable for the hedge fund industry and certainly more desirable than self regulation. Since industry representatives are constrained by their members, we believe that they cannot put themselves in a position to promote codes of conduct that would be sufficiently strict.
- Furthermore, industry bodies are not in a position to monitor the actual application of the codes they put forward. By promoting codes of conduct that tend to focus on increasing investor confidence, they actually bring about problems of moral hazard.

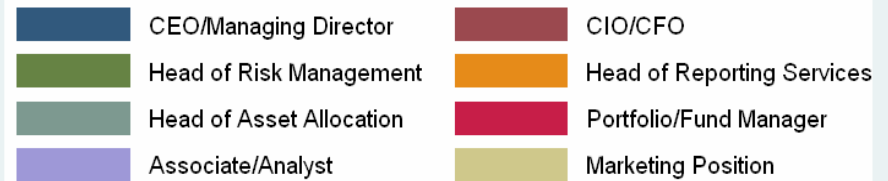
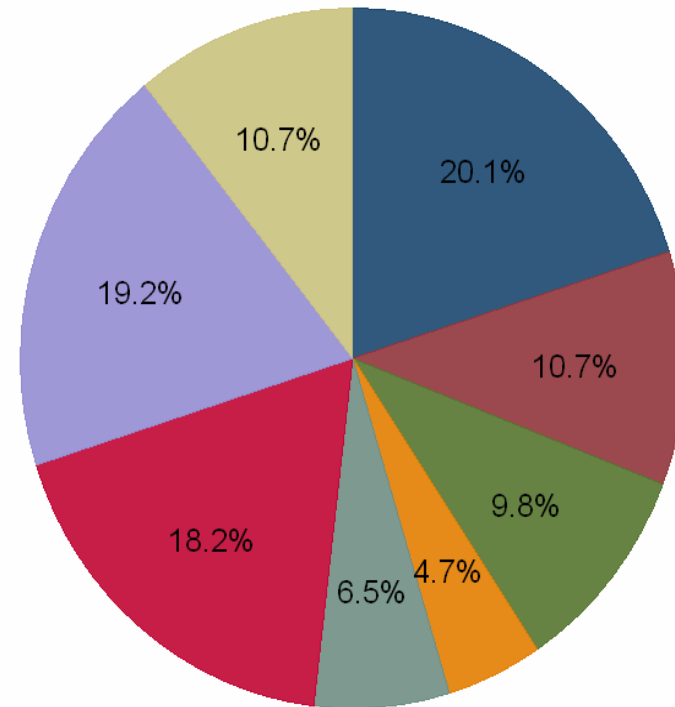
# EDHEC European Survey

EDHEC surveyed 214 European hedge fund players in summer 2008

Profession of survey participants

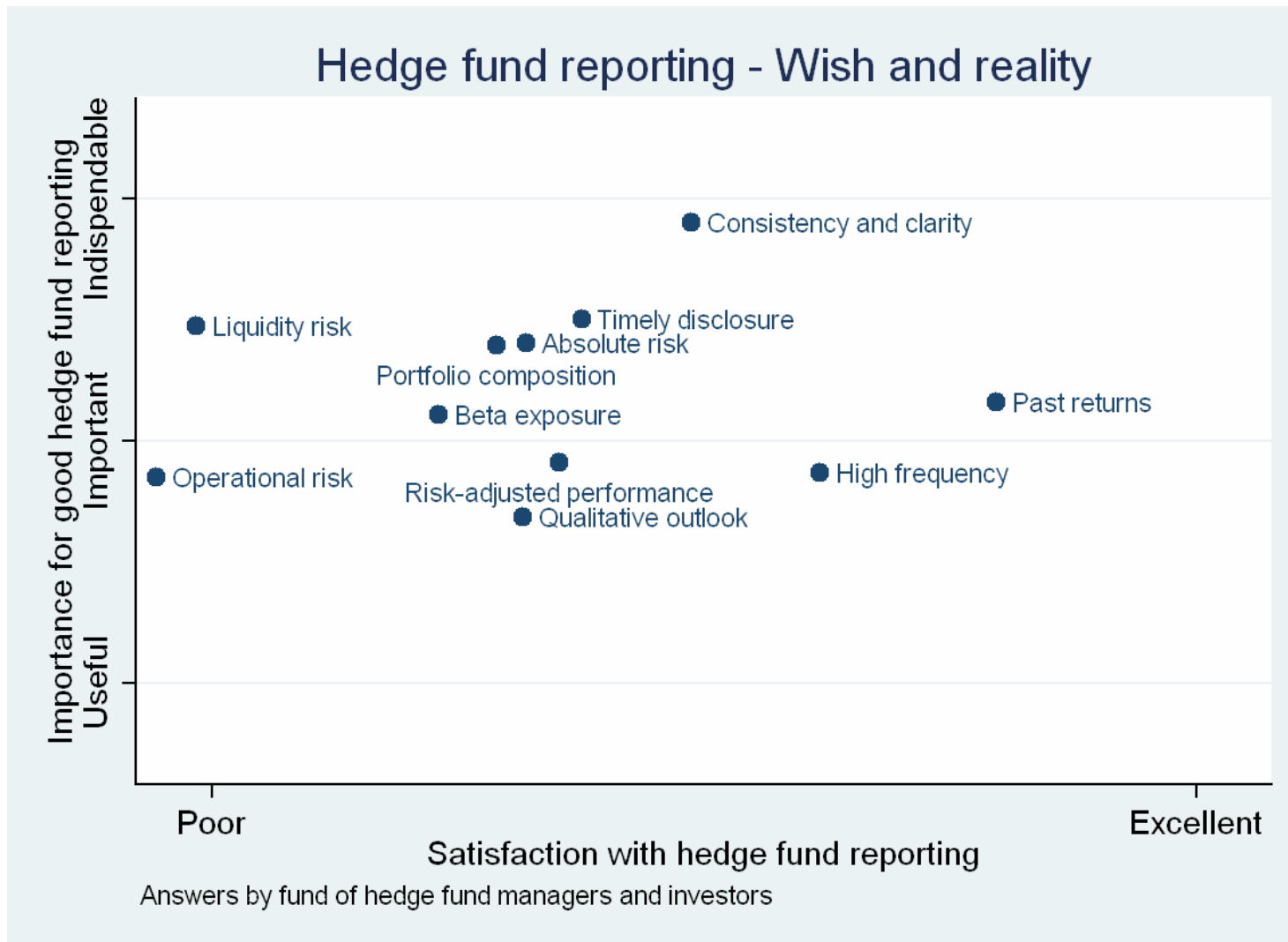


Function of survey participants



# EDHEC European Survey Conclusions

## Hedge fund disclosure does not meet investor expectations



# EDHEC European Survey Conclusions

Industry practices fall short of academic standards for hedge fund reporting

	Academic Literature	Industry practices
Non-normality of hedge fund returns	Hedge fund returns are not normally distributed (Agarwal and Naik, 2004)	62% do not know how to test for non-normality 68% prefer Shape ratio
Dynamic factor exposure of hedge funds	Linear factor models are not appropriate (Fung and Hsieh, 1997)	78% use linear factor models
Alpha analysis	Should be based on factor models; peer groups inappropriate (Sharpe, 1991)	about 50% prefer peer group or HF index
Smooth returns due to illiquid assets	Hedge fund returns are smoother than they ought to be (Getmansky et al., 2004)	only 5% use return smoothing-robust measures

# EDHEC European Survey Conclusions

Industry guidelines fall short of providing sufficient guidance

	AIMA	HFSB	MFA	PWG	IOSCO
Reporting style	+	+	+	O	
Valuation framework	+	+	O	O	+
Past returns	O	O	+	O	
Extreme risks		O			
Factor exposure				O	
Portfolio composition					
Leverage risk	O	O		O	
Liquidity risk	O	+		O	
Hedge fund structure	O	+	+	+	
Operational risk	+	+		+	

# Going forward

- Rather than attempting to forbid unsound practices (supposing that the regulator is able to detect them before they hurt the investor), why not favor sound practices?
- Why not favor, for example, under a certain number of strict constraints, the cross-border distribution (with advertising) of single hedge funds or funds of hedge funds and at the same time investment in those vehicles with:
  - Formal segregation of assets and independent responsibility for valuation and control
  - Assets handled in the form of managed accounts
  - Greater transparency of financial and operational risks

# Going forward

- In addition, and specifically to cope with issues recently highlighted by the financial crisis, the best response to the question of the management of liquidity risk could be:
  - Promotion of listed closed-end funds where investor liquidity is managed through a secondary market without impact on the actual assets of the fund, hence avoiding a liquidity conflict with the underlying investments
  - Reinforcement and harmonization of transparency on actual risk exposures, including an assessment of the risks of liquidity (e.g., through disclosure of the % of assets whose liquidity is low or subject to market conditions)

# Conclusion: Caveat Emptor

- In the end, everything has to be done so that investors feel responsible for their investment decision:
  - “Modest” communication approach by the regulator
  - Rather than attempting to develop internationally recognized rules (hence, very often limited to the smallest common denominator), which usually have a great “advertising” effect that encourages overconfidence, why not favor transparency and the disclosure of information on operational risks. For example, this could be achieved with the creation of a global and official database of information on operational problems identified (managers, custodians, prime brokers involved in significant operational or liquidity issues, fraudulent or not).
- Increasing the financial community’s memory of the losses caused by operational risks will help ensure investor protection. It is, in all likelihood, one of the great coming challenges.