

EU COMMISSION OPEN HEARING ON HEDGE FUNDS AND PRIVATE EQUITY

FEBRUARY 26TH & 27TH 2009

OPENING REMARKS BY COMMISSIONER CHARLIE MCCREEVY:

In his opening remarks, Commissioner McCreevy reviewed the role of hedge funds and private equity in the financial crisis and drew some lessons regarding the need for EU level regulation of these fund types. The financial crisis had revealed that hedge funds could impact financial stability in ways that had not previously been expected. There is also widespread concern about the extent to which private equity portfolio companies are over-reliant on increasingly scarce bank debt, raising questions about their financial viability. In order to respond to relevant concerns, the Commission will come forward with legislative proposals before the end of April.

Commissioner McCreevy proposed that legislative initiatives action in this area should respect six principles: (i) the role and the impact of these fund types were quite different and require differentiated responses; (ii) any EU legislative intervention should build on extensive experience with regulation and supervision of these managers at national level; (iii) investors in hedge funds and private equity remain almost exclusively institutional or sophisticated and should be able to perform proper due diligence on their own investments subject to receiving certain key information; (iv) the management by lending institutions of credit to hedge funds and private equity portfolio companies was the first line of defence in preventing the build-up of leverage in these businesses; (v) a number of issues that were being discussed in the context of hedge funds and private equity like short selling were not unique to them and need to be tackled as part of a more comprehensive policy; and (vi) measures should ideally be consistent at global level given the international character of the industries concerned.

MR POUL NYRUP RASMUSSEN, MEP, PRESIDENT OF THE PARTY OF EUROPEAN SOCIALISTS:

Mr Rasmussen recalled that the European Parliament had issued a clear call for regulation of hedge funds and private equity in autumn 2008. He cited the statement of G 20 November summit 'that all financial market players and products should be regulated and supervised appropriately'. Mr Rasmussen believes that hedge funds contributed to the build-up and depth of the crisis. According to him, the need for EU legislative action is now proven.

Turning to private equity, Mr Rasmussen took the view that the time for self-regulation was over. Existing codes of conduct did not address important issues like taxation, excessive debt burdens on portfolio companies, or excessive manager fees. There are no credible sanctions to punish managers that do not comply with their commitments.

The EU should lead the way towards global regulation. Other jurisdictions would follow this lead. There was a strong possibility that the new US administration would be more open to implementing similar actions in the US.

EU level regulation of hedge funds and private equity would also benefit the internal market. The managers would not have to comply with 27 national regimes. This would increase transparency and reduce costs.

- PRIVATE EQUITY -

SIR MICHAEL RAKE, BRITISH TELECOM AND CHAIRMAN OF THE (WALKER GUIDELINES) COMPLIANCE MONITORING GROUP:

Sir Michael emphasised that private equity has evolved significantly in its attitudes towards transparency towards authorities and the wider public. While recognising that many private equity managers had traditionally been reluctant to make public disclosures, there was now a widespread understanding that openness to stakeholders was essential for the continued success of the industry. Sir Michael explained the background to the 'Walker guidelines' which have become the reference point for disclosures by private equity managers about their portfolio companies. He reported on the encouraging results of the monitoring work of the first year of application of the guidelines in the UK.

In addition to these self-regulatory practices, UK private equity managers are also supervised by the FSA. In addition, company law applies fully to the private equity firms – and this brings to bear important provisions relevant to concerns such as capital depletion/asset-stripping.

Therefore, **Sir Michael's** message to the European Commission was that the guidelines were evolving. An increasing

number of BVCA members are signing up to these guidelines. Furthermore, private equity associations in other Member States had adopted similar codes.

When considering the need for EU level regulation three factors should be taken into account: private equity covered a rich variety of strategies; about 85% of their activities were of a local or national nature; and the application of guidelines like the Walker guidelines at EU level would be a much more flexible instrument than regulation.

Sir Michael concluded by recalling that, in the vast majority of cases, private equity is not a threat to firms. On the contrary, it is a far superior outcome to bankruptcy – which is sometimes the only alternative.

PROFESSOR MICHAEL WRIGHT, DIRECTOR CENTRE FOR MANAGEMENT BUYOUT RESEARCH, NOTTINGHAM UNIVERSITY BUSINESS SCHOOL:

Professor Wright presented the results of a considerable body of research, including recent new research by Nottingham University Business School. Overall, this research showed that private equity had a positive impact on portfolio companies – boosting profits and productivity in the 3 years following buy-

outs. These improvements could not be attributed only or even primarily to use of debt to restructure portfolio company finances. Divestments of company assets do occur – but these are not observed systematically. Prof. Wright stressed that account also has to be taken of the fact that private equity funds are often investing in firms in difficulty. Therefore, it would not be correct to compare the performance of these companies directly with, for example, industry averages. This could explain, in part, the observed reduction in employment and salaries in the first years after a private equity financed take-over/transfer of control. However, even greater employment rationalisation is observed in the case of companies involved in mergers/acquisition.

There has been a growth in leverage in private equity finance deals – but this leverage is still below levels observed in private equity deals in the 1980s. 12% of buy-outs fail. High leverage is found to increase likelihood of failure. However, leveraged private equity firms are less likely to fail than equally leveraged family or other firms.

PANEL 1: PRIVATE EQUITY BUSINESS MODELS: WHAT ARE THE POSITIVE AND NEGATIVE IMPACTS ON MARKETS AND STAKEHOLDERS? WHAT ARE THE PUBLIC POLICY ISSUES?

Moderator: Ms Amanda Harvie, independent consultant, former CEO of Scottish Financial Enterprise

Panellists:

- *Mr Reiner Hoffmann, Deputy General Secretary, European Trade Union Confederation (ETUC)*
- *Mr Kurt J. Lauk, Member of the European Parliament*
- *Mr Jens Lundager, Deputy Permanent Secretary, Financial Affairs, Danish*

Ministry of Economic and Business Affairs

- *Mr Magnus Lundberg, CEO, Phadia*
- *Mr Jonathan Russell, Chairman, European Private Equity & Venture Capital Association (EVCA), 3i Managing Partner Buyouts*
- *Mr Jan Ståhlberg, Deputy CEO, EQT*

The panel first discussed the perception of private equity (PE) from different perspectives.

Mr Jan Ståhlberg underlined the high level of success of private equity in Scandinavia dating back to early 90s. There have been no significant failures of private equity firms in the region over this period.

In the discussion, **Mr Reiner Hoffmann** drew attention to the fact that the issue of remuneration needed to be addressed by regulation to prevent private equity managers extracting surplus value from portfolio companies – to the detriment of the long-term prospects and sustainability of the portfolio companies. He pointed to the fact that if returns paid to investors were high, the returns earned by the PE fund manager were often even higher and could only be generated by aggressive amortisation of the assets of the company over a short to medium term.

Mr Kurt Lauk pointed out that the debate about private equity was more about perception than about content. The main issue was a negative perception of private equity in public opinion which the PE industry has failed to address. This had been seized upon by politicians – and would be an issue in the forthcoming European Parliament elections. In the current climate it was no longer possible to avoid regulation. According to Mr Lauk, self-regulatory codes had lost their credibility. The

private equity industry should therefore start thinking about what kind of regulation it could live with. Some issues like transparency would most likely not harm the business model. He was less clear on how regulation could address issues such as excessive gearing of portfolio companies.

Mr Jens Lundager agreed that more transparency about remuneration of portfolio company management would be appropriate. He informed the audience that Denmark had introduced new rules recently which seek to restrict payments made by bidders in general, for example by PE fund managers, to incumbent management in portfolio companies. There is in Denmark a prohibition against making agreements on share options, bonuses and other incentive-based benefits with a target company's management in connection with takeover bids - from the time when actual negotiations on a takeover bid, including the recommendation of a takeover bid, commence and until such time as the negotiations are discontinued or the takeover bid is completed

Such prohibition ensures that management loyalty towards shareholders would not be called into question in context of takeover bids.

Furthermore Mr. Lundager proposed an EU-level duty for the bidder to disclose, before an acquisition, information about any contemplated distribution of funds (payment of dividends etc.) from the company subsequent to the completion of an acquisition. This would ensure increased openness towards shareholders.

This would specifically imply that an offeror who has not disclosed information on payments of funds from the target company after the completion of an acquisition would be barred from distributing funds from the target

company to the offeror or its related parties for a period of 12 months.

Mr Lundager recommended these rules as a benchmark for the EU. He recognised the danger that overly restrictive EU regulation could restrict the scope for business in Europe.

The panel then considered the effect of private equity financing on portfolio companies.

Mr Magnus Lundberg, as a representative of a portfolio company, informed the hearing about the positive impact of private equity on his (medical diagnostics) company. According to Mr Lundberg, private equity enhanced efficiency and performance significantly by promoting excellence in management and aligning interests between capital providers (fund) and the management of the portfolio company (which is given a stake in the company). From his experience, public companies had a shorter-term time horizon due to their reporting requirements towards the public and shareholders: private equity tends to take a longer-term view. He dismissed concerns about asset-stripping or PE managers running portfolio companies into the ground. This would not be in their interests as PE managers will want to 'exit' their investment at a certain time: they will not be able to do so if the company is worthless at the time of disposal. Therefore, he saw limited risk of the scenario where PE managers focus on short-term profit maximisation at the expense of long-term company viability. Governance was more elegant in portfolio companies as there were clear investment agreements and bank agreements. He considered it inevitable that employment decreased in the first phase of a restructuring of what are often companies in difficulty. However, if successful, there would be job-creation later.

Mr Hoffmann challenged the upbeat assessment of the employment effects of

private equity. He referred to a study by the Boston Consulting Group and the University of Navarra which estimates that up to half of the private equity investments might go bankrupt in the next two years. This posed not only a big risk for employment but for the economy as a whole. In Mr Hoffmann's view, private equity strategies for portfolio companies were often not sustainable, certainly not if they had to produce a return of 15-20% over a period of five years or more.

Mr Lauk quoted the findings presented to the World Economic Forum. This work suggests that private equity is not a job-killer – nor is it the job-creator that some of its advocates sometimes argue.

Mr Jonathan Russell observed that private equity had an important role to play in the battle to emerge from the current global economic crisis. Private equity did not have a systemic impact as each individual investment was ring-fenced and funds were not faced with a possible run on the fund. Furthermore, total lending by banks to PE portfolio companies amounted to less than one percent of the aggregated balance sheets of all EU banks. Therefore, the banking system was not vulnerable to systemic shocks having their origin in private equity financed business. Large short-term flip-overs, although widely discussed in the political sphere, were very rare and were also undertaken by other (non-PE) investors. Private equity funds remain invested for an average of five years – which is longer than any other investor category. In addition, the industry is currently regulated extensively in Europe, as demonstrated in the Industry Response to the European Parliament and the European Commission of 25 February 2009.

The panel then debated issues relating to PE manager remuneration.

Ms Amanda Harvie asked panellists if they believed that PE managers had been over-compensated. **Mr Russell** observed that the typical structure of PE fees ensures that their interests are aligned with those of investors. 'Carried interest' means that PE managers only get paid when investors have received 8% returns.

Mr Lauk was critical of some obscure and worrying examples of bad remuneration practice. He cited cases where incumbent management had been rewarded for acquiescing to PE take-over. The incumbent managers had profited from the PE takeover – but the company was subsequently run with very short-term time horizons. Capital outlays and expenditure on product development were drastically reduced allowing profits to increase significantly over a 4-5 year period. However, the long-term prospects of the company had been heavily compromised.

The panel then discussed how private equity manages its relations with investors and stakeholders in portfolio companies. Panellists agreed that this was an area where more could be done to improve the situation. All saw it as necessary for private equity managers to communicate openly and clearly with stakeholders and the public. It was necessary for PE to explain its approach and objectives when making individual investments. It could also work harder to explain the basic business model.

Mr Stahlberg argued that investors in private equity already received detailed information. It was, however, important to avoid situations where some investors receive privileged information. All investors should be provided with equal access to information.

Mr Hoffmann regretted that poor relations between owners and worker representatives were not confined to some private equity owned companies,

but extended across other industry sectors. He believed that much could be improved with regard to disclosure and transparency. Trade unions would be willing to work constructively with private equity owners in a climate of greater transparency and trust.

Mr Lundager and **Mr Russell** agreed that most of the issues discussed in relation to private equity did not relate directly to private equity funds per se. Instead, the concern is with the relation between portfolio companies and the public. There was already extensive disclosure by the PE manager and company to investors. Communication with the management of portfolio companies was also close. What is needed is greater transparency to other stakeholders about PE ambitions for portfolio companies, and performance of the latter following transfer of control.

Mr Lauk insisted that private equity was a good business model, had grown significantly, and could be a valuable source of finance in the context of current shortage of investment capital. The industry had to establish a more productive relationship with trade unions. Otherwise, PE would be on the back-foot the whole time.

In concluding, **Ms Harvie** noted that private equity did not present a risk to overall financial stability. The external challenge for the industry is to improve its engagement with other stakeholder groups. Any policy discussion should focus on enhancing transparency, building on existing industry initiatives whilst being mindful of the differing conditions within individual EU Member States. She recalled that her home country (Scotland) is predicted by economic forecasters to become the world's third most state-dependent country with public spending on course to rise to the equivalent of 67% of the country's GDP by 2012. There is a danger of the public sector crowding out private enterprise if

attractive conditions for business investment are not present. The private equity industry is an important source of investment capital and must be able to thrive in Europe if we are to avoid the risk of a bloated public sector.

PRIVATE EQUITY PANEL 2: DO SELF-REGULATORY CODES AND NATIONAL REGULATORY PROVISIONS ADDRESS THE CHALLENGES? IS EU LEGISLATIVE ACTION NEEDED?

Moderator: Professor Michael Wright, Nottingham University Business School:

Panellists:

- *Prof. Dr. Dr. Ann-Kristin Achleitner, Co-Director of Center for Entrepreneurial and Financial Studies, Technische Universität München;*
- *Mr Wim Borgdorff, Managing Partner, Fund Investments, AlpInvest Partners ;*
- *Mr Simon Cox, European Works Council Coordinator, European Federation of Food, Agriculture and Tourism Trade Unions (EFFAT);*
- *Mr Matthew Fann, Associate, UK Financial Services Authority (FSA);*
- *Mr Vincenzo Morelli, Partner at TPG Capital LLP, Chairman of the European Liaison Group of global buyout firms ;*
- *Ms H el ene Ploix, Chairman, Pechel Industries and former chairman of the French Private Equity Association (AFIC).*

The second panel assessed how effectively the key concerns raised in relation to private equity are addressed by existing legislation at national and European level – and whether further legislative steps at EU level are needed.

As regards capital requirements, **Ms H el ene Ploix** explained that existing national or European regulatory frameworks ensure that private equity management companies have sufficient

capital to cover their operational risks - the only real risks that they are facing. No additional layers of risk based capital are needed at that level or at the level of a fund. She recalled that a fund is a contract between investors and the management company and does not incur creditor or liquidity risks or even operational risks particularly as in France, funds assets are under custodianship.

Mr Vincenzo Morelli rebutted systemic risk accusations levied against private equity industry. He pointed out that private equity does not pose any such problems in that: (i) private equity funds do not hold any cash on behalf of investors and do not have any redemption commitments towards them. Therefore, private equity funds can not be subject to a crisis of confidence by investors leading to a “run on the bank”. (ii) Private equity industry almost never contracted debt at the fund level and ring-fenced each investment by its funds separately, without being subject to any cross-default clauses. This limits risk of a crisis of confidence by lenders, leading to loans being called in and forced asset sales. (iii) Private equity total LBO leverage was small on a macro-prudential basis, representing less than 1% of total European bank assets in 2007, according to the European Central Bank. (iv) Private equity industry did not trade securities, let alone short them, nor does it write Credit Default Swaps or similar policies, so could not pose a counterparty risk of any magnitude.

Mr Matthew Fann recalled that, in the UK, authorised private equity fund managers are subject to regulatory oversight. These requirements impose appropriate capital/solvency/liquidity requirements and enable regulators to request any relevant financial information. **Ms Ploix** further explained that, in general, neither private equity

managers nor the funds they manage are leveraged. The level of debt in a portfolio company is negotiated with prudential/lending institutions who take into account the company's ability to repay loans.

Mr Simon Cox expressed strong concerns about the unsustainable levels of debt in portfolio companies. He stated that this was the main issue of concern for trade unions. He predicted that that many thousands of jobs will be lost because excessive debt in portfolio companies has left them unfit to cope with the economic downturn.

When discussing disclosure requirements, **Mr Wim Borgdorff** distinguished between the appropriateness of disclosures already provided by private equity and other disclosures which could potentially add value. Other panellists agreed that private equity investors, as professional or sophisticated entities, already receive sufficient information to complete their due diligence processes before investing. However, **Ms Ploix** indicated that wider disclosure on management companies, their registration, strategy, procedures, compliance regime, oversight etc would help private equity to be better understood by the general public.

Mr Borgdorff said that disclosure to, and interactions with, portfolio companies and its stakeholders is one of the most regulated areas at national level. **Mr Cox** challenged this view: he believes that current disclosure under codes of conduct such as Walker Guidelines in the United Kingdom is wholly inadequate in scope and depth. He claimed that European regulation on information and consultation of employees does not sufficiently address the question of private equity ownership of employers. He proposed revision of the Transfer of Undertakings Directive in order to extend the obligations under this Directive to

cover transfers of control to private equity (as majority shareholders) and stressed the need for the European Works Councils of portfolio companies to be able to consult with their private equity owners.

Prof. Ann-Kristin Achleitner pointed out that it is important to distinguish between concerns stemming from regulatory failure and those having their roots in perception. She stressed that sufficient data exist to dismiss claims of "asset stripping" by private equity funds. Data also suggest that sale of assets reflects the role of private equity as a "change agent" as there are also more acquisitions in private equity that do not only take place after some time but relatively early on, after an acquisition has taken place.. Symmetrically, the role of private equity as a "change agent" can explain the development of employment under private equity ownership. Over time and as the private equity strategy is implemented, jobs are reduced, but new jobs are being created in green field operations.

Mr Cox questioned the methodology used in generating much of the data supporting the case for private equity.

According to **Mr Morelli**, private equity business model does not entail any significant conflict of interest issues. He underlined this fact by saying that this is due to the very strong alignment of interests between investors and private equity managers. **Mr Fann** noted the recent FSA research tends to confirm this

general conclusion. However, this research also points to areas where private equity firms lack appropriate internal procedures for dealing with conflicts of interest.

The panel reflected on the need for a new European regulatory regime directed towards private equity.

In general, it was recognised that not all Member States address similar issues and risks via the same level of regulatory oversight. Panellists agreed that in some countries the current patchwork of existing industry codes is not complete or fully effective. Some panellists advocated that industry codes should have a role to play alongside any new regulatory regime. The trade union representative stressed the need for European regulation with real sanctions, citing the industry's history of regulatory arbitrage and proven ability to ignore public disapprobation. Industry representatives recommend that private equity should engage actively in building up of a new pan-European regulatory framework that can work for all parties concerned. Any new regulatory regime should recognise differences between national laws, should be proportionate to the risks it is trying to address, and should maintain a level playing field among all investor types (family offices, industrial holdings, sovereign funds etc.). Finally, the new regime should avoid fixing problems that stem from inadequate enforcement of existing laws and regulations.

CLOSING SPEECH¹ BY MR JOUYET, PRESIDENT OF AUTORITÉ DES MARCHÉS FINANCIERS

¹ Mr. Jouyet's speech (in French) is available at: http://www.amf-france.org/documents/general/8776_1.pdf

Mr Jouyet strongly pressed for the creation of a new European single private equity vehicle. He voiced concerns that hedge fund-related risks for the market, for the banking system and for their investors, as well as some deficiencies in governance of hedge funds are not sufficiently addressed by the patchwork of regulations in the EU. He expressed the wish that the European Commission will propose a secure and harmonised European framework applicable to alternative funds and their managers, based on best practices in terms of governance, disclosure, risk management and product distribution.

Mr Jouyet pointed to the numerous benefits of the creation of a "European label" for the European alternative investment industry, subject to compliance with the requirements set out in such a framework. A European initiative could harmonize and secure the regulatory framework applicable to the alternative funds industry, but it could also lay the foundations for a single European market and permit the cross-border marketing of registered European alternative funds. It would enhance the attractiveness of the European asset management industry, foster dissemination of best practice and improve investor protection. The European Union can play a leading role in creating, in cooperation with asset management industry, a regulatory environment for alternative investment which will become the reference point for policymakers and regulators around the world.

The G20 called for regulation of all financial players and pointed out the need for relevant regulation of hedge funds. **Mr Jouyet** concluded that regulators would need a clear direction from political leaders and institutions as to the content of required regulation.

SPEECH BY ANTONIO BORGES, CHAIRMAN OF THE HEDGE FUND STANDARDS BOARD: 'RECENT DEVELOPMENTS, VIEWED FROM THE MARKETPLACE'

Mr Borges urged humility from regulators in the wake of widespread market and regulatory failures during the financial crisis. He saw regulation as an indispensable feature of the financial markets but emphasised the complementary role played by industry standards in translating regulatory principles into concrete behavioural norms. Such norms could be enforced by investors and operated on a 'comply or explain' basis, which he considered to be an important addition to the regulatory framework.

Whereas many had expected the next financial crisis to emerge from the hedge fund sector, the reality was that in comparison with other sectors, hedge funds had proved to be responsible and resilient; no hedge fund had required a public bail-out. This was in spite of the adverse effects of investor panic and regulatory interventions (in particular the curbs on short selling, which he considered to have been ineffective and based on a misunderstanding of the role of short selling). He attributed this resilience to a superior understanding of risk among hedge fund managers; to the fact that hedge fund managers typically invest alongside their clients; and to powerful market discipline. He also felt that, contrary to popular perception, the limited use of leverage in the sector was a factor in their resilience. These features allowed hedge funds to withstand shocks and to remain invested in adverse conditions. Markets are therefore more complete with hedge funds than without.

Looking ahead, **Mr Borges** recognised that investors would demand high standards from hedge funds, and that hedge funds would unquestionably have to provide greater transparency and disclosure towards investors and regulators, although not necessarily to the public at large. Hedge funds were willing to take collective responsibility for the future of the industry and were prepared to engage actively with regulators to achieve this. Transparency, independent administration and valuation, and good governance would be the guiding principles.

Concluding, **Mr Borges** argued that the focus of regulators is correctly on systemic risk but that this was of limited relevance to hedge funds. He also noted that investor protection efforts should be focused on retail investors, not the professional investors that account for the bulk of hedge fund investment. Notwithstanding this, he reiterated the willingness of the industry to share relevant information and argued that cooperation between regulators and the industry in developing standards would be more effective than pure regulation.

HEDGE FUNDS PANEL 1: HEDGE FUNDS, FINANCIAL STABILITY AND MARKET INTEGRITY: WHERE ARE THE VULNERABILITIES?

Moderator: Professor Jon Danielsson, LSE

Panellists:

- *Mr Segun Aganga, Managing Director and Head of Hedge Fund Consulting, Goldman Sachs Prime Brokerage, Europe and Asia;*
- *Mr Christopher Fawcett, Former chairman, Alternative Investment Management Association (AIMA) and*

Managing Partner of Fauchier Partners (FoHF);

- *Mr Aerdts Houben, Director Financial Stability Division, De Nederlandsche Bank;*
- *Mr Dietrich Jahn, Deputy Director General, International Financial and Monetary Policies, Federal Ministry of Finance, Germany; and*
- *Mr Gareth Murphy, Senior Advisor, Bank of England.*

In his opening presentation, **Dr Aerdts Houben** (De Nederlandsche Bank) recognised the political imperative for regulatory action in the hedge fund sector but cautioned regulators against throwing the baby out with the bathwater. He argued that hedge funds contributed to the efficiency and liquidity of financial markets and were a driver of financial innovation. While he did not believe that hedge funds had been a prime source of the financial crisis, their activities had amplified cyclical movements in the market with real costs in terms of wealth destruction, growth and employment.

Dr Houben drew a distinction between the credit channel and the market channel for the transmission of systemic risk. The 'indirect approach' to the regulation of hedge funds via the regulation of prime brokers and other counterparties had worked well to mitigate the risk of hedge fund failures leading to 'domino effects' in the banking sector and to the disruption of the payment system. However, hedge fund activities could also generate systemic risks through their impact on market dynamics. The tightening of credit conditions in response to market volatility had resulted in extensive hedge fund deleveraging, thereby contributing to market turbulence. He stressed the need to take account of these market

impacts and urged regulators to consider how these pro-cyclical effects could be attenuated.

He concluded that there was a clear need for regulators to get a better grip on risks arising from the hedge fund sector through international efforts to enhance the transparency of the sector, to impose registration and integrity requirements and, to the extent that hedge funds behave like banks, through liquidity and solvency requirements.

The panel then discussed lessons from the financial crisis

Mr Gareth Murphy (Bank of England) noted hedge funds delivered an average return of -20% in 2008, many hedge funds closed and end-investors suffered losses. Despite this, however, the sector was free of moral hazard in the sense that the crisis had not resulted in the public bail-out of a single hedge fund or a single prime broker as a result of its hedge fund exposures. Nevertheless, he felt that important lessons had been learnt from the crisis: the failure of Lehman Brothers had taught hedge funds to diversify their prime broker relationships; and the Madoff case had underlined the need for investors to undertake thorough due diligence. He explained that hedge funds do pose systemic risks (i) as borrowers from prime brokers and (ii) through their extremely active trading in asset markets. Prime brokers had managed their credit risk to hedge funds so well since the LTCM-crisis that recent events post-Lehman may swing the pendulum back in favour of hedge funds when negotiating terms for prime brokerage. He concurred that regulators need to share extensive amounts of information in order to get an adequate overview of prime brokerage exposures to a geographically dispersed hedge funds industry.

Mr Christopher Fawcett (Fauchier Partners and former Chairman, AIMA) disputed a widely held perception that hedge funds are bigger than they actually are: total assets under management currently stand at less than \$1.5 trillion, comparable to a large bank. According to a Goldman Sachs survey, hedge fund holdings account for only 2.9% of US equities and 2.2% of short positions, less than the largest mutual fund managers. **Mr Fawcett** said that the problems faced by the industry were not caused by leverage, but by the illiquidity of key markets.

Dr Houben acknowledged that leverage levels may not be high throughout the industry but noted that there is a wide distribution, with some funds highly leveraged. The process of deleveraging in the hedge fund industry had been more severe in the past 6 months than in other sectors. **Mr Murphy** recalled that it was important to focus on leverage levels in the steady state, not the explosion of leverage in stressed market conditions.

The panel then reflected on whether indirect regulation/supervision (or prime brokers and HF counterparties) has proved effective.

Mr Segun Aganga (Goldman Sachs) viewed hedge funds not as a source of systemic risk but as systemically important market participants. He also stressed the need to look at the problems of illiquidity of assets and increasing redemptions which go beyond hedge funds to other investor classes. He noted that prime brokerage activities had not been a source of bank failure and that risk management had improved significantly since the near-collapse of LTCM in 1998. Specifically, the assessment of counterparty risk in hedge fund exposures has improved, lending to hedge funds is now typically collateralised and prime brokers were

conscious of the reputational impact of lending to certain types of counterparty. In the UK, the FSA collects regular data from prime brokers, covering aggregate financing exposures together with the collateral taken and the identities of the 20 largest exposures. He suggested that the template used for this data collection could be rolled out on a European or global basis. This data collection is combined in the UK with targeted monitoring of prime brokers, with a particular focus on risk management systems and collateral management.

Mr Murphy highlighted the risk management and regulatory challenge of a hedge fund having prime brokerage relationships with many investment banking groups which have prime brokerage entities located in different regulatory jurisdictions. To illustrate the concept of systemic risk and the need for information sharing, he mentioned his experience at LTCM where the prime brokers of the fund did not know prior to August 1998 how big the fund was. Each thought that they were the biggest provider of services to the fund with 50%-60% share of the fund's business only to learn in September 1998 that each had only one-eighth of the LTCM's business. This meant that the fund was seven times bigger than any single prime broker had expected.

The panel debated the impact of hedge fund activity on market efficiency and integrity:

Mr Fawcett outlined the differences between hedge funds and other investment vehicles, notably the commitment to provide absolute returns and the long notice period for redemptions. The ability to buy when others sell and to use hedging techniques allows hedge funds to provide diversity in the market and to contribute to price discovery. He recognised that hedge fund

'activism' could impact on the performance of individual securities but noted that if hedge funds were excluded from such activities, listed companies would be left with 'absentee landlords'.

Mr Murphy explained that short selling served an important economic purpose, by facilitating price formation and boosting market liquidity, and as a risk management tool. He explained the difference between uncovered and covered short selling using the analogy that a person buying a house would expect the seller to be able to show him where the house is. He then went on to explain that the Madrid Stock Exchange had long-standing rules which financially penalised sellers of stock who failed to deliver at settlement date (which is what uncovered short sellers risk). Several other panellists stressed the distinction between naked and covered short selling; **Dr Houben** noted that the Dutch authorities had recently extended a ban on naked short selling due to its potential impact on market volatility. It was recalled that abusive short selling – for instance, based on the spreading of false rumours - is illegal.

Mr Dietrich Jahn (German Finance Ministry) noted that short-selling had impeded capital raising in some cases, although he recognised the role that short positions play in risk management and hedging. He also noted that some aggressive activist behaviour had been witnessed in Germany but that the response from the community had served to curb this behaviour.

Finally, the panel reflected on the type of information that regulators need to understand the macro-prudential/systemic impacts of hedge funds.

Mr Jon Danielsson (LSE) warned that increased transparency might result in regulators being provided with more

information than they can handle; and could lead to moral hazard.

Mr Jahn emphasised that regulators required a more solid base of information on the sector, so as to ensure that macro-prudential oversight incorporates all major market players. He noted that the "Issing Expert Group" in Germany therefore recommends the establishment of a global risk map as well as a global credit register. He welcomed the apparent willingness of the industry to supply this information. He explained that the German authorities will ask for regular delivery of key data and information on risk management tools, to allow authorities to identify risks in systemically important funds and in groups of smaller funds. He pointed out that hedge funds may become a source of systemic risk, as in the current crisis the stabilising effects of hedge funds were significantly reduced and a pro-cyclical behaviour of hedge funds was revealed. Therefore, he supported an EU-wide system of registration. He also saw an important role for global supervisory cooperation and hoped that the differences in approach and culture between the EU and US could be overcome to achieve a common approach. He envisaged a key role for the IMF in providing early warnings of systemic risks. He questioned the need for off-shore funds in the European market.

Mr Aganga saw a case for greater transparency in stock lending and short selling but insisted that any reporting requirements must be applied at least on an EU-wide basis so as to avoid arbitrage. He called for increased dialogue between hedge funds, other market participants and the regulators and warned that political debates could obscure the real policy issues.

Dr Houben reiterated that greater transparency was required to allow

regulators to look at structural vulnerabilities in the hedge fund sector across the economic cycle.

Conclusion

In summary, **Mr Danielsson** noted that the panellists had identified both positive and negative impacts of hedge fund activity. Significant improvements in risk management had been made in the wake of LTCM and hedge funds make a positive contribution to financial markets. However, their activities also generate risks and may have amplified market volatility.

HEDGE FUNDS PANEL 2 "MANAGEMENT OF MICRO-PRUDENTIAL RISKS & TRANSPARENCY TOWARDS INVESTORS"

INTRODUCTORY REMARKS BY MR JEAN RENÉ GIRAUD, DIRECTOR, EDHEC RISK & ASSET MANAGEMENT RESEARCH CENTRE.

Moderator: Mr Peter de Proft, Director General, European Fund and Asset Management Association (EFAMA)

Panellists:

- *Ms Carin Bryans, Managing Director, J. P. Morgan Bank (Ireland) plc;*
- *Mr Grellan O'Kelly, Derivatives and Complex Product Policy Specialist, Irish Financial Services Regulatory Authority;*
- *Mr Dirk Söhnholz, Managing Director, Feri Institutional Advisors GmbH, Co-Chairman of Bundesverband Alternative Investments e.V. (BAI);*
- *Mr Johan van der Ende, Chief Investment Officer, PGGM Investments (Netherlands);*

- *Dr Prof Erik Vermeulen, Member of the Legal Committee of European Issuers, Corporate lawyer at Philips International BV and Professor of Law at Tilburg University, The Netherlands.*

The panel relating to micro prudential risk management started with a presentation by **Mr Jean René Giraud**. Mr Giraud's presentation was informed by a recently conducted European survey on hedge funds. It showed a clear failure of external risk control constraints and national regulations. Hedge funds are today mostly regulated through 'indirect regulation' based on lending constraints applicable to their prime brokers. And on industry self regulatory initiatives, according to the recent survey, specific constraints on liquidity management and false perception of independent and fair (esp. for illiquid assets) valuation have misled investors and increased moral hazard. These shortcomings have had some adverse and cyclical effects on the industry and global financial markets. To conclude, **Mr Giraud** called for more efficient and sound practices across Europe. This could be accompanied by increased scope for cross-border distribution of hedge funds subject to compliance by the hedge fund managers with some important conditions. These conditions should relate to the custodianship of fund assets; reinforced responsibility with regard to valuation and control procedures; and practices including responsibility of auditors regarding the actual published NAVs. HF managers should also be transparent as regards their financial (including liquidity) and operational risk management. Mr Giraud considered that the managed accounts model offered some inherent advantages, notably in offering greater liquidity to investors. He also suggested promoting investor

liquidity through a secondary market for closed-end funds.

For **Ms Carin Bryans**, stricter rules on corporate governance and independence of key processes are the keys to improved risk management by hedge funds. The hedge fund business model should provide for a manager, an administrator, a prime broker and where appropriate, a custodian, all independent of each other. She suggested applying some of the UCITS governance rules to HF since both sectors have converged recently. One actor, for example the custodian, could be entrusted with broader oversight responsibility for the administration and the management of the fund. **Ms Bryans** observed that transparent and sound practices on the part of valuation agents and custodians are crucial safeguards against fraudulent and abusive behaviour. She also highlighted that the infrastructure for clearing and settling transactions in certain complex asset classes (credit derivatives) has lagged behind growth of the market – leading to greater operational and settlement risk for hedge funds trading in these instruments.

Mr Grellan O'Kelly concurred with the need for hedge funds managers to implement independent processes. Most European HF managers already implement organisational arrangements where key processes are independent of the manager – and this approach needs to be extended globally. Hedge funds managers should implement appropriate stress testing and operate effective controls on liquidity, credit and collateral risk. According to **Mr O'Kelly**, a good hedge fund manager can understand and manage the risks associated with the investment under both normal and stressed market conditions.

Mr Söhnholz highlighted the counterparty risks from having a single prime broker and the related problem of

brokers having a limited picture of the HF. He was dismissive of the effectiveness of HF boards as an effective governance tool. **Mr Söhnholz** pointed to some weaknesses in the managed accounts model: even if the managed account has full transparency on the HF portfolio, it does not necessarily have the ability to accurately value the positions. Also managed accounts represent a departure from the principle of equal treatment of investors- as the managed account platform receives privileged treatment and liquidity conditions.

Mr Peter de Proft recalled recent commentary on convergence between hedge funds and UCITS III. He inquired whether hedge funds implementing UCITS III strategies were able to comply with the strict risk management requirements of UCITS III. **Grellan O'Kelly** confirmed that UCITS III was sufficiently flexible to accommodate most HF investment strategies. UCITS requirements on valuation and asset custody were a solid basis for managing risk across all investment strategies.

For **Mr Johan Van der Ende**, hedge funds remain a good alternative to equities for institutional investors – in that they provide diversified and managed exposure to risk. Institutional investors need to invest in complex and riskier assets as this is where the greatest chance of high returns lies. But professional investors should only rely on hedge funds managers who can demonstrate expertise in managing the risks that are the corollary of higher returns. As professional investors, **Mr Van der Ende** insisted on the importance for the investors to complete their own due diligence processes and to increase their understanding of the funds strategy they want to invest in. To that extent, investors should be provided on a regular basis with accurate information on the funds risk management tools, and stress *scenari*

which is to **Mr Van der Ende's** view, an essential part of understanding how the hedge funds is managed and its trading techniques.

On the issue of activism, **Professor Erik Vermeulen** contended that many activist hedge fund investors are long-term investors in companies and work to ensure implementation of new strategies. While normally beneficial, abusive hedge funds activism can sometimes actively seek to destabilise market prices to make profit. From the issuers' point of views, such abusive practices can destroy the value of the firm and should be more strictly policed. In response to a question from the floor, **Professor Vermeulen** conceded that there have been few cases where this type of behaviour has been proven. This is because such behaviour is difficult to detect and prove intent. **Professor Vermeulen** proposed that a 'leniency' programme be established for whistle-blowers – along the lines operated in anti-trust law. Managers denouncing abusive strategies by their peers would be spared from sanctions or penalties.

According to **Mr Dirk Söhnholz**, the micro prudential regulation of hedge funds should primarily focus on the relationship between the funds and its investors. Hedge funds are a good source of portfolio diversification for investors. However, investors have to assume their responsibilities, properly understand investments and investment strategies if they are to invest successfully in hedge funds. If they do not have the expertise themselves, they should be willing to pay for expert opinion. In his experience, too many investors are reluctant to pay for expert support in selecting and monitoring HF investments being content instead to follow the crowd. This tendency is particularly notable when times are good. The regulatory framework for HFs should focus on

ensuring that information is disclosed equitably to investors and good respect of the funds contractual arrangements.

Mr Peter de Proft invited the panel to comment on how the industry had responded to the crisis. According to Carin Bryans, investors had stepped up their focus on due diligence when selecting investments. There was greater demand by investors for increased disclosure and transparency around hedge fund process and controls. HF managers were signing up in greater numbers to self-regulatory codes. **Mr Grellan O'Kelly** underlined more intense investor scrutiny. He also indicated that the industry is looking to draw and implement lessons from the crisis. At the moment, this process was only in its early stages – industry is still reacting to events. It is still too early to talk about a coherent industry response.

The final section of the panel focused on the need for and form of EU intervention in respect of HF risk management.

Professor Vermeulen observed that some form of action was needed but that self-regulation was seen as inadequate. On the other hand, prescriptive regulation could prove ineffective in dealing with issues such as conflicts of interest and transparency. He advocated a form of co-regulation where public authorities assume a hands-on role in implementing codes and practices developed by the industry.

Mr Söhnholz also pointed out that if risk management was to be regulated at European level, the regulation should focus on returns based analysis ideally based on independent third party and frequent data and assuming non-linearity and multi factor analysis, but not detailed position analysis which may be misleading. To this end, more detailed information and data and regular reporting should be available to build up

the industry memory and have a more accurate and deeper understanding of the hedge funds activities. Ms Bryans warned against creating a false sense of security by requiring increased reporting to regulators in isolation.

Mr Peter de Proft summarized the discussion with the following remarks:

- Any supervisory interest in hedge fund risk management should focus on corporate governance, valuation, liquidity and operational risk management issues;
- The EU hedge fund industry has traditionally separated the main functions of management, administration, valuation and asset custody. This model has proved effective and should be the starting-point for any future regulatory action;
- Hedge funds are complex products targeted at professional investors who should understand how the managers' transform market risk into high returns. Investors due diligence remains essential to successful investment in hedge funds. If investor due diligence is to be effective, hedge funds will have to provide more comprehensive disclosures to their investors.

CONCLUDING PANEL: INTERNATIONAL REGULATORY AND SELF-REGULATORY RESPONSES TO ALTERNATIVE INVESTMENTS: IS THERE AN EMERGING CONSENSUS?

Moderator: *Mr Eddy Wymeersch, Chairman, CESR.*

Panellists:

- *Mr David Banks, Director, Securities, Jersey Financial Services Commission;*
- *Mr. Thomas Biolsi, Associate Regional (NY) Director, Investment Advisers and*

Investment Companies, US Securities and Exchanges Commission;

- *Mr John G. Gaine, President Emeritus and Special Counsel, International Affairs, Managed Funds Association (US MFA);*
- *Ms Nicoletta Giusto, Director of International Relations, CONSOB;*
- *Mr Jiri Krol, Director, Financial Markets Analysis and Development, Ministry of Finance of the Czech Republic;*
- *Ms Florence Lombard, Executive Director, Alternative Investment Management Association (AIMA) ;*
- *Mr Dan Waters, Director Asset Management, UK Financial Services Authority (FSA).*

Mr. Wymeersch opened the panel by highlighting the potential regulatory issues stemming from the growth of hedge funds. He mentioned systemic risk (excessive leverage and herding behaviour); dominant market position; market abuse; propensity to risk induced by remuneration; and investor protection. He mentioned that there are already a number of countries that regulate hedge fund managers or hedge funds. He drew attention to the IOSCO Task Force on Unregulated Financial Entities – February 2009 Consultation Paper. He applauded the self-regulatory code of the HFSB. However, he asked how the HFSB code could be enforced and its application monitored. He also offered several recommendations regarding the possible regulation of hedge funds. He suggested that information on systemic funds, or larger high risk funds could be gathered indirectly (from prime brokers). Further, he said that Managers should be licensed and monitored especially with respect to: risk management, compliance function, robust valuation techniques, asset segregation, independent audit, adequate

capital resources, and management of conflicts of interest.

Updates on US and International developments: Panellists provided an update on emerging regulatory/legislative developments in US and other leading alternative investment jurisdictions.

Mr Biolsi said that as international regulators attempt to find common ground for the appropriate regulatory oversight, they need to recognise a number of operating environment differences for the alternative fund industry. The risks that they pose for investors, even sophisticated ones, issuers individual counterparties and market risk, there must be a clear understanding of these differences.

When you develop an intimate understanding of many of these firms you realize that the issues of non-transparency; performance fees; the concentrated economic positions they take in certain companies and industries; their highly developed information networks with corporate executives, broker-dealers, issuers and investment banks; their lack of expense caps as well as their direct access to investors assets makes this a very challenging industry. When we look back over the past two years and matters we are currently working on and see the problems that have arisen with regard to safeguarding investor assets, valuations, conflicts of interest, insider trading, potential manipulation, questionable uses of lockups and gates along with problematic marketing practices and capital raising activities, we are faced with an industry that requires us to look at it very differently. It also requires us to cooperate in a much more coordinated way to deal with the global nature of

many of their operations and economic impact.

Mr Biolsi argued that we cannot afford to look at individual hedge funds in isolation nor can we ignore the growth in size and complexity of the industry. To increase regulation for hedge funds and their managers, a bill has been introduced in the US Senate which would require registration of HF managers.

Mr Gaine stated that the proposed US legislation (several bills in the House and Senate) would maintain restrictions on marketing HF investments to retail investors, require registration of HF under the Investment Company Act, and introduce central clearing of CDS contracts. He noted that many US fund managers are registered somewhere under multiple supervisory authorities. He agreed that there should be no (regulatory) gaps in the future and that all managers should be subject to oversight. He also called for the development of consistent, global regulatory rules within the G20 process.

Ms Lombard called for a global approach to HF regulation. She outlined AIMA's views on what an enhanced, appropriate and proportionate regulatory framework could look like. This would include: a global manager-authorisation and supervision template based on the UK's FSA model; unified global standards for the industry based on the convergence of existing industry standards work, such as that authored by AIMA, HFSB, IOSCO, PWG and MFA; regular reporting to national regulators of systemic positions/risks, in particular, reporting of volatility, liquidity and leverage by asset class and investment strategy; and an aggregated short position disclosure regime to national regulators and new policies to reduce settlement failure (including in the area of naked short selling).

Ms Giusto noted that the central issue for self-regulatory codes was the credibility of compliance and sanction mechanisms. No convincing solution has emerged in 20 years of experience with these codes. She also stated that the players in HF business are regulated in different countries but usually for different reasons- giving rise to a patchwork of regulatory controls. Although measures for brokers and HF managers are being debated she called for a functional approach.

Mr Banks stated that HFs domiciled in Jersey are fully regulated and that his administration cooperates with other regulators around the world. He described the main features of Jersey regulatory system. The HFs are tax transparent, i.e. investors are taxed in their home country; HF administrators are supervised and required to be domiciled; HF accounts are to be audited by Big 4 auditors. He pointed to an obvious difficulty in regulating hedge funds – the difficulty of properly defining the asset class.

Jersey was a founding signatory to the IOSCO multilateral memorandum of understanding on international assistance and supported the call for all jurisdictions to sign up to it. Jersey is committed to matching international standards of regulation and would comply with whatever such standards emerged from the current review.

Mr Waters asked what information the regulator actually needs. He stated that UK system would focus on regulation of HF managers. Regulation of prime brokers would be further enhanced.

Is there still space for self regulation?

Mr Gaine, Ms Lombard and **Mr Waters** viewed industry codes as a useful complement to regulation. The discussion highlighted that the main problem with

the self-regulatory approach was deemed to be its enforcement. Mr Krol suggested that both approaches (regulation and self-regulation) should be combined e.g. by requiring mandatory membership in industry associations.

Are we faced with prospects of expensive regulatory fragmentation at global level?

Ms Giusto called for agreement on global principles and raised the question of off-shore jurisdictions. Ms Lombard highlighted the high cost of compliance if different jurisdictions developed competing/conflicting regulation. She called for a system of mutual recognition at international level. Mr Waters called for a consistent international approach based on sound HF managers regulation.

Mr Krol cautioned against a 'UCITS light' regime as regards the definition of investment strategies and diversification which would create moral hazard. He suggested that the reporting obligation be rather prescriptive and consistent globally. Otherwise gains from regulation would be diminished. He called for any EU initiative to include the possibility of recognising third country equivalence and warned against the EU turning inward. **Ms Lombard** stressed the importance of agreement on the reporting template.

Mr Biolsi acknowledged the need for global standards. He noted the different situation of the US with the problems of multiple regulators and oversight bodies and multiple jurisdictions in the US. He was optimistic regarding the prospects for convergence between the US and EU standards in the long term given the apparent agreement on fundamental issues.

How to regulate a globalised / offshore business ?

Mr Waters stated that the issue of offshore jurisdictions should not distract us from pursuing the appropriate

regulatory approach as the main players (HF managers, brokers) are onshore. **Mr Wymeersch** referred to the Stanford case noting that concerns relating to offshore centres are not confined to tax issues. Mr Banks recalled the willingness of Jersey authorities to cooperate and apply whatever international consensus emerges. **Ms Giusto** acknowledged the existence of the Memorandum of Understanding regarding the information exchanges. She warned that some offshore funds fall outside the offshore supervisory system and no information is disclosed to the local supervisor. She also raised the question of the verification that the principles/standards are applied.

To conclude, Mr Wymeersch summarised the panel discussion:

- The rules/standards should be globally comparable (based on globally agreed principles);
- There was broad consensus that regulation should focus on HF managers, including HF manager registration;
- The progress should be made on the EU level to avoid regulatory fragmentation within Europe;
- Effort is needed to ensure that offshore jurisdictions apply international rules/practices.

CLOSING PRESENTATION: MR DOUGLAS SHAW, MANAGING DIRECTOR, PROPRIETARY ALPHA STRATEGIES, BLACKROCK.

Mr Shaw detailed the extensive disclosures that his company provides to investors. This comprises a wealth of information on investment strategy and liquidity and risk management. Judging by the very rare cases for additional information, this level of information seems to be sufficient for most professional investors.

Conventional wisdom was that hedge fund failure could threaten financial stability by bringing down systemically relevant institutions or banks. However, this has not been the case and hedge funds have rarely defaulted on their obligations. Ironically, Lehman debacle had highlighted the extent to which hedge funds are vulnerable to failure of their prime brokers. Increasingly hedge fund managers focus heavily on assessing the robustness of prime-brokers.

Mr Shaw challenged the lack of evidence to justify restrictions on short-selling. On the contrary, academic research tends to support the positive impact of short selling on liquidity and efficiency of price formation. He asked where the evidence was to support the UK FSA imposition of disclosure requirements on 'large' short positions. **Mr Shaw** recalled the importance of short selling in forcing UK authorities to abandon their costly adherence to ERM exchange rate targets in early 90s. He presented charts showing that short selling restrictions had not been effective in preventing continued decline in the price of UK financial stocks. The imposition of these controls implies costs for the market – in terms of reduce efficiency and for hedge fund managers – in terms of compliance costs and regulatory overhead (FSA estimates a one off cost of £40'000 and ongoing costs of £72'000 p.a.).

In general, **Mr Shaw** challenged the unsubstantiated perception of hedge fund managers as a threat to market integrity. Of 145 enforcement actions taken by FSA in period 2005-2008, only 2 involved hedge fund managers.

In concluding, **Mr Shaw** argued that hedge funds form part of the market 'eco-system'. The benefits of hedge fund contribution to market functioning should be valued – not inhibited by unnecessary and costly disclosure requirements.