

**BAI Comments on the  
Report of the Alternative Investment Expert Group on  
Managing, Servicing and Marketing Hedge Funds in Europe**

## **A. General Remarks**

The Bundesverband Alternative Investments e.V. (BAI) welcomes the opportunity to commend on the report of the Alternative Investment Expert Group on managing, servicing and marketing hedge funds in Europe of July 2006. Given their increasing market share, the consideration of the market and regulatory environment for hedge funds on a European level at this stage is particularly valuable. We wish to commend on the expert group's description of the role of hedge funds in the financial system and on the description of the hedge fund market in Europe. There is obviously need for a renewed and non-prejudiced view on the hedge funds industry, which recognises in particular the beneficial influence of the instruments funded by hedge funds. Hedge funds are global market participants. An appropriate regulatory approach should therefore be considered on a global, rather than a European dimension.

There is a great risk of over-regulation on a national level impeding further innovation. Rigorous regulation would conflict with the current flexibility of hedge funds, which makes up a lion's share of the attractiveness of these products. Whilst we appreciate that some action has been taken in non-EU jurisdictions we do not believe that the right balance between interference and flexibility has already been found. Also globally agreed measures must remain limited in scope and serve to fix clear market failures. To identify whether this is the case, a cost-benefit analysis should be carried out for each of the measures considered. Against these basic considerations we share the expert group's assessment that the existing light-touch regulation does not need amendment, but should rather be supported through targeted non-legislative steps at a European level. We furthermore agree with most of the practical recommendations made by the group.

## **B. Comments on the recommendations**

### **I. Regulations for retail investors**

#### *Making hedge funds and related products available to retail investors*

We find the introduction of a minimum threshold and the enforcement of clear conduct of business requirements appropriate tools to ensure a sufficient degree of investor protection. We disagree with the expert group's recommendation to implement a minimum threshold of 50,000 Euro as an adequate benchmark.

To introduce investment opportunities in hedge funds to a wide range of investors' public marketing of single hedge funds should be introduced if the minimum investment amount exceeds 10,000 Euro. This amount excludes inexperienced retail investors from hedge fund investments but allows at the same time an appropriate portfolio diversification of most other investors. The proscription of the public distribution of single hedge funds leads to a massive inflow even of retail capital into unregulated structured products and certificates linked to hedge funds, increasing investment fees significantly.

#### *Authorisation of funds of hedge funds as UCITS*

The expert group noticed both advantages and potential disadvantages in re-opening the negotiations on making hedge funds and related products available to retail investors. However, by no means should a potential qualification of funds of hedge funds as UCITS products hamper the evolution of the hedge funds market itself. We would therefore oppose any additional regulatory requirements on the individual hedge funds being introduced by this backdoor.

### *UCITS investments in derivatives on hedge fund indices*

The BAI would disagree with the expert group's assessment that there ought to be more certainty on the reliability and functioning of hedge fund indices before UCITS investment in these instruments is authorised. We are astounded to learn that there was almost unanimity on this conclusion among the experts. We believe that there might be benefit in such a possibility and would suggest that more consideration be given to this in the White Paper.

Most of the investable hedge fund indices consisting only of hedge funds open for additional investments are expected to comply with the respective CESR- and IOSCO-criteria of adequate indexation such as the ones calculated and published by CSFB, Dow Jones, Feri, MSCI and FTSE.

The UCITS Directive does not provide for any details on the nature of the financial index as an underlying of derivative instruments explicitly. Most of the investable hedge fund indices cover different styles that broadly represent hedge fund investing (Arbitrage, Event-Driven, Equity Hedge and Directional/Tactical). Hedge Fund Index construction usually uses rigorous quantitative and qualitative methods to determine fund selection. As a general rule the index construction process involves different complementary procedures.

Initially the number of funds required to construct a representative and investable index is determined. In further procedure a universe of suitable candidates for inclusion in the index is determined. This process begins with the examination of strategy consistency, screening the hedge fund sample for self-reporting bias and inconsistency to create a candidate pool cohesively defined in terms of styles and strategies. The candidate pool is then further screened for length of track record, assets under management, and investment capacity to ensure investability. Should a hedge fund which is part of the index be closed, that particular hedge fund is replaced at the next rebalancing point.

Concerns regarding selection bias are unfounded. In general, it is impossible to under report a poor hedge fund performance because their returns are reported on a regular basis and reporting failure would usually mean expulsion from the index. Index reporting on a daily basis

may not be implemented in either case because many hedge funds do not provide day-to-day reporting systems. At the same time over reporting by successful hedge funds generally may not appear since hedge fund and strategy weightings are usually fixed.

In general the different hedge fund indices equally weight the styles and strategies, providing investors convenient means to achieve broad diversification across the major hedge fund strategies. This is consistent with creating a representative index that reflects a passive investment approach that diversifies both hedge fund strategy risk and manager risk over time. The rules governing construction and maintenance of the index — e.g. (annual) rebalancing to equal weights and the procedure to change index constituents — are clear and publicly announced.

As to fund removals and additions index funds are generally required to undergo regular due diligence reviews. Representativeness analyses are periodically repeated on the “universe” which includes new qualifying funds. The index continues to reflect the actual returns generated by the hedge fund in question until such a time as it is replaced. At the time of replacing, the historical data is not adjusted.

As to concerns on consistency of the sector of hedge funds of which the index is representative, the BAI considers that there is a well defined universe of hedge funds. Selection criteria usually start by looking at hedge funds with a certain track record during a defined period of time and those which have at least a certain amount of assets under management. Hedge fund index providers doing ongoing market analysis, basing their research on a universe of hedge funds drawn from major hedge fund data bases and determine how and where assets are being allocated across the entire hedge fund universe.

Interesting, most investable hedge fund indices show very similar risk/return characteristics with very low risk and low correlation with established asset classes. Given the diverse nature of hedge funds and the lack of worldwide complete hedge fund databases, this in our opinion shows the suitability of such indices for derivatives. Through the low correlation with traditional but also other alternative investments the inclusion of such derivatives in UCITS in general can be used to reduce the risk of UCITS by giving the fund managers additional options to diversify their portfolios.

*Mutual recognition of nationally regulated retail-oriented hedge funds*

Mutual recognition of the hedge funds that have been recognised in one EU country by other supervisory authorities would be a very powerful achievement in improving the market environment of hedge funds in Europe. We would strongly support efforts in this direction, especially if funds of hedge funds were continuously not recognised as UCITS-compliant.

**II. Regulations for institutional investors**

*Remove quantitative restrictions on hedge-fund based investing*

Institutional investors should be able to freely decide on the investments that best serve their clients needs and especially be able to diversify their investments across many asset classes and instruments to reduce risks according to the “prudent person principle”. Transparency and disclosure requirements are the best instrument to serve financial stability purposes. These requirements should apply to both the managers of hedge funds and the institutional clients, in their function of providers of financial services.

*Appropriate implementation of the Capital Requirements Directive and appropriate provisioning requirements under Solvency II*

We agree that inadequate limitations on the investments made by institutional investors must be avoided, also in the context of the implementation of the Capital Requirements Directive and as regards the Commission’s forthcoming Solvency II proposals.

### **III. Close cooperation with US- supervisory bodies**

We strongly support the expert group's view that close cooperation with the US Securities & Exchange Commission and with other relevant parties ought to be ensured to secure exemption from the US registration requirements for European hedge fund managers wishing to do business with US qualified investors, in the case that such rules should be re-implemented

### **IV. Hedge Fund Servicing**

#### *Free choice of custodianship within the EU*

On a fundamental basis we support the idea of free choice of custodianship within the EU. However, this relies on a number of preconditions and especially on the clarification and harmonisation of the role and responsibilities of depositaries across the EU. Regarding the role of depositaries of hedge funds we request the Commission to give in its White Paper particular attention to the relationship between hedge funds and prime brokers. In most cases, the latter fulfil themselves the function of custodian and thus we strongly recommend not to make the use of custodians mandatory. This would only increase the complexities of processes and increase cost for many strategies without apparent benefits for investors. Consequently there might occur conflicts of interests between prime broker and custodian when these functions are allocated with the prime broker.

#### *Monitoring of sub-custodians and harmonisation of requirements to be appointed as custodian*

We agree that custodians have an important role to play in monitoring the sub-custodian. We also believe that a minimum assets test or a minimum credit rating are suitable requirements to ensure that custodians have a sufficient size and market standing to fulfil their functions.

*Issues on re-hypothecation should be treated as commercial terms of business to be negotiated between the fund and the prime broker*

We strongly agree with the expert group's opinion that re-hypothecation limits are a critical economic variable contributing to the cost and price of providing the prime brokerage service. Neither Member States nor the Commission should therefore impose any regulatory restrictions upon re-hypothecation limits for European hedge funds. As any right of re-hypothecation should be transparent to investors through disclosure in the fund offering documents such matters should be clearly and exclusively regarded as commercial terms of business to be negotiated between the respective parties, the fund and the prime broker.

As demonstrated by the expert group any restriction on re-hypothecation creates an increase in financing and securities borrowing costs for the fund. These costs reduce the returns available to investors. Enforceable set-off clauses in the brokerage documentation seem to be adequate tools to prevent the investor of any loss that might occur when a prime broker falls insolvent. If enforceability of such clauses can not be assured due to different legal systems involved, the sales prospectus might contain specific information in this respect.

*Asset valuation standards in the EU should be based on the IOSCO report*

The BAI would agree with the expert group's recommendation that standards for asset valuation in the EU should be based on the report that is currently prepared by IOSCO. Adopting a global approach on this question is in line with the consideration that hedge fund regulation would be inappropriate if agreed specifically for the EU. An internationally agreed system of best practice does indeed seem the best approach to this matter.

*This opinion was issued on the 19 September 2006. For any further information on this comments please contact:  
Bundesverband Alternative Investments e.V., Poppelsdorfer Allee 106, 53115 Bonn, Germany.  
Phone: +49-(0)228-96987-0; Fax: +49-(0)228-96987-90; E-mail: [info@bvai.de](mailto:info@bvai.de)*