

1 September 2006

REPORT FROM THE ALTERNATIVE INVESTMENT EXPERT GROUP -SUBGROUP ON HEDGE FUNDS-

Introduction

UNICE has taken note of the *Report of the Alternative Investment Expert Group – Managing, Servicing and Marketing Hedge Funds in Europe*, published by the European Commission in July 2006. UNICE participated as an observer in the Expert Group's Subgroup on Hedge Funds.

Europe's corporate sector acknowledges the benefits hedge funds bring to financial markets, both from the point of view of liquidity as well as risk dispersion. They can provide liquidity in securities in which traditional investors are less willing to trade. They can contribute to a better distribution of risks on the financial markets, for example as active participants in credit default-swap markets. They are an important driver of innovation. Hedge funds as providers of capital can thus play an important role in the economic allocation of capital and in enhancing the efficiency of financial markets.

Over the past decade, hedge funds have become important shareholders in Europe's companies. It needs to be ensured that hedge funds bring long-term value to the companies they invest in. This poses a number of challenges from a corporate governance point of view, and also with regard to market efficiency. UNICE feels that these issues have not been adequately addressed in the report.

The group was asked to make recommendations regarding the regulation needed to dismantle barriers to cross-border business of hedge funds. The question of whether regulation of the industry itself was required, or adjustments to regulation applicable to all institutional shareholders, motivated by hedge funds' activities, was not the subject of discussions.

However, these two aspects complement each other: market forces can only release their full potential if market participants, in particular issuers and investors, can be reassured that their dealings with hedge funds take place within a regulatory framework providing for market information, shareholder transparency and investor protection. For this reason UNICE regrets that the ambit of discussions within the expert group set up by the Commission was not widened to include both aspects of regulation.

1. Improve Shareholder Transparency

The most significant concern to companies is in identifying their membership. A high level of market information about the ownership of a company is important in order to enable investors to make economically efficient decisions and to ensure an undistorted price setting mechanism. In particular, knowledge about major transactions in a company's share can help investors understand share price fluctuations and prevent undue volatility.

As most of the shares are held by custodian banks or a sequence of custodians, it is ultimately at the investor's discretion whether he wants to let the company know the total amount of shares he holds. When it comes to shareholder meetings, it is hence very difficult for companies to ensure that the true holders of the voting rights are those which are enfranchised. Some hedge funds, in common with other market participants, lend and borrow shares, including voting rights and it is difficult for the company to establish in reality how many shares they own. This is particularly problematic in the areas of takeovers and affects not just the company but also the other members. While public investment funds of the UCITS type need to disclose their holdings on a regular basis, this is not the case for hedge funds.

The Transparency Directive addresses disclosure requirements of beneficial owners and also the disclosure of persons holding the right to vote. However, its efficiency in ensuring shareholder transparency depends to a large extent upon the implementation of the directive in each member state.

Currently, EU law foresees, at the lower end, a notification threshold for major holdings of voting rights of 5% (Art. 9 of the Transparency Directive). It seems advisable to introduce another lower notification threshold at 3%, as some countries are doing in their national implementation of the Transparency Directive. This would need to be done by way of EU legislative action. In order not to add to bureaucracy for shareholders and to remain in the spirit of "better regulation", it should be possible to make notifications in a cost-effective way. Lower notification thresholds would also alleviate the problem of "acting in concert", whereby several investors who remain below the 5% threshold can achieve a voting majority if participation rates at shareholders' meetings are low. In the past, this has been a problem for a number of companies in particular with regard to hedge funds as shareholders.

2. Contain undue market volatility

Because of their complicated business strategies and their often intransparent dealings, hedge funds are prone to incur large gains and losses according to market developments. They borrow from banks and investment firms in order to pursue these strategies, thus exposing their counterparties to the risks involved. A large number of hedge fund assets are hard to value because they are complicated or illiquid financial instruments, posing a risk of disorderly liquidation should the markets turn.

Hedge funds employ a range of financing techniques which have not been traditionally available and are used to a much lesser extent by other types of funds. One of these business strategies relates to short sales. While short sales can increase market efficiency, they can also, depending on the market situation and in particular in combination with highly leveraged positions, pose particular challenges for market transparency, liquidity and volatility. In an environment of falling share prices, these so-called Long-Short-Equity strategies, which are short-term by nature, can increase downward pressure on share prices beyond economically justified levels. A distinctive difference to other types of investors is that hedge funds do not only speculate towards rising, but also towards falling asset values.

Related to this is the strategy of hedge funds to borrow a company's shares from other investors, in order to increase their voting power at the general assembly. In the framework of these longer-term strategies, aimed at increasing shareholder value hedge funds often put pressure on management which may be contrary to the long-term interest of the company.

3. Heed Against Market Abuse

Potential market manipulation and insider trading by participants in the financial markets are of great concern to issuers as they have a significant impact on companies' share prices. These activities might be highly profitable for hedge funds due to their specific structural features and business techniques. The Market Abuse Directive, which has now been implemented in most EU countries addresses these issues already. We therefore look to regulators to apply the directive robustly. Also, more market transparency in reporting transactions in which hedge funds are involved, in particular with regard to derivative financial instruments, might improve regulatory surveillance of potential market abuse practices.

4. Recommendations

We agree with the group's conclusions that specific regulation of the hedge fund industry should only address risks that are specific to hedge funds and that the strategies described above are also pursued by other investors. We believe that the challenges hedge funds as investors in Europe's companies pose to corporate governance and market efficiency should, at this point, be addressed by improving the transparency of shareholdings in general, with specific disclosure requirements for short selling positions and borrowed securities.

- A further, lower notification threshold should be introduced in the Transparency Directive, preferably at 3%.
- Fund managers ought to be required to disclose information on short sales to the issuer if asked by him directly. Knowing the identity of the short seller is in the interest of the issuer also because it allows him to target his investor relations work more closely to this group of investor.
- Holdings of borrowed securities should be notified to and published by stock markets. Lending fees should be monitored more closely and published by an official agency. As share lending is closely related to short selling, this information can be a first indication of the trends in short selling.

However, it needs to be borne in mind that, while the risks identified above derive from business strategies which are not exclusive to hedge funds, these strategies are nevertheless used to a much greater extent by hedge funds than by other market participants. The impact of hedge funds' activities on corporate governance and on financial markets needs to be monitored more closely in the future to determine whether the envisaged measures to increase shareholder transparency will be sufficient to ensure that hedge funds deliver the potential benefits to financial markets and bring long-term value to Europe's companies.

* * *