

**EUROPEANISSUERS' COMMENTS**  
**ON THE**  
**WORKING DOCUMENT OF THE COMMISSION SERVICES (DG INTERNAL MARKET)**  
**CONSULTATION PAPER ON HEDGE FUNDS**

**11 February 2009**

EuropeanIssuers welcomes the consultation the European Commission is undertaking in view of a possible regulatory initiative regarding hedge funds.

**1. SCOPING THE ISSUES**

***1) Are the above considerations sufficient to distinguish hedge funds from other actors in financial markets (especially other leveraged institutions or funds)? If not, what other/additional elements should be taken into account? Do their distinct features justify a targeted assessment of their activities?***

The considerations are all correct and well stated. One very important aspect is not yet covered and should also be mentioned. A typical investor in a company or a bond is interested in the company itself as an economic undertaking and would base its investment decision on the essentials of the company, its business and business prospects and thus the sustainable profitable growth of the company. Such investors want to make a profit on their investment in the company by holding on to their participation. Even if one core aspect of such striving for profit is the possibility to sell the share, such sale would normally not take place very shortly after acquiring the holding in a company, and indeed maybe never if the company performs well.

A classical hedge fund has a different approach and a different goal: A hedge fund is not interested in the company but only in deriving a profit from price movements in the securities of the company. The interest of hedge funds is centred only on the factors which affect the price developments of such security in a market. Since price movements are the result of supply and demand and triggered by the behaviour of market participants, the essence of hedge fund behaviour is projecting and exploiting the price movements in a security as well as the expected behaviour of other market participants. The company itself is not the essence of the investment. Hedge funds are therefore not investors in the company but only in the security and their decisions are driven by the desire to exploit movements in the share price whatever causes them and even if such movements have to be triggered by using financial tools, sometimes very sophisticated, capable of influencing the share price.

***In short: Real investors are shareholders who invest in the company, hedge funds are generally traders who do not invest in a company but exploit market price movements.***

While this is the principle, the distinction between the different types of investors is not always that sharp. Even more traditional investors use financial techniques that are typical for hedge funds and sometimes hedge funds claim to be long time investors. But even when traditional investors use such techniques, for instance to hedge the value of their holding in a company against future losses by buying a put option, such does not change their basic investment approach.

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

A global response may cover all hedge funds and all financial markets. Considering the different approaches to the matter and the different interests of governments, such response may be difficult to achieve. While it is evident that economically financial markets have global aspects, the regulations and the supervision of each market are still also national. The European markets are organised, regulated and supervised by European and/or national authorities. Market regulations which provide rules for behaviour on those markets will cover all participants in those markets, European and non-European. That is the reason why we believe a European approach will be effective which is not to say that international co-ordination or convergence should not be striven for.

Sometimes the danger of the “flight to the most liberal market” is evoked when discussing the issue. But markets are organised in a way that trading in a security by professionals will almost always take place in the most liquid market for such security. Since hedge funds and other funds are professional market participants it can be expected that they will still trade on the most liquid market even if this market has better regulation in order to protect investors (e.g. long time shareholders) against unwanted consequences of hedge fund activities. If European securities are listed only or mainly in Europe, one should expect this will still be the case after putting better regulation in place.

## **2. SYSTEMIC RISKS**

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

Systemic risk occurs whenever a failure of one individual institution can trigger material adverse consequences for a significant number of other institutions, i.e. the failure of one entity can endanger the viability of its counterparties. This was certainly the case for hedge funds during the 1998 LTCM crisis. It can be said that recent developments have demonstrated that hedge funds may impact broader market considerations and dynamics. From a systemic point of view, it may become evident that the business model of hedge funds will encounter difficulties which could force rapid and disorderly unwinding of positions in various asset classes with wider consequences for market liquidity. This could have potential knock-on effects for other market participants, for example, through counterparty exposures in derivatives markets.

But responsibility for the deleveraging cycle may have to be shared between hedge funds and banks. Hedge funds seeking leverage can obtain funding either through margin financing from a prime broker or through private repo markets. These markets have deteriorated as margin financing from prime brokers has been cut, and haircuts and fees on repo financing have increased. The combination of these factors has caused average hedge fund leverage to fall to 1.4 times capital from 1.7 times last year according to IMF statistics. This caused the beginning of a vicious circle.

With these counterparty concerns from hedge funds, some prime brokers have experienced a sharp decline in liquidity as hedge funds have shifted funds from their prime brokers into segregated accounts or into trust vehicles. Moreover many hedge funds are reducing their concentration in a single prime broker after the Lehman Brothers bankruptcy. In turn, prime brokers are tightening lending standards or have ended their relationships with hedge funds. As a consequence, these actions reinforced the broader deleveraging of the financial system.

One important means to reduce risk in the financial system and in market relationships involving hedge funds would be a move from omnibus accounts to segregated accounts. Omnibus accounts do not provide a definite allocation of securities or other assets capable of being credited to an account but may contaminate safe assets with risks which should be confined to some of the assets or only to the bank administering the omnibus account. In order to reduce systemic risks omnibus accounts should not be allowed where such use can increase risks to investors, to the financial system or the market indeed.

***4) Is the 'indirect regulation' of hedge fund leverage through prudential requirements on prime brokers still sufficient to insulate the banking system from the risks of hedge fund failure? Do we need alternative approaches?***

We are not in favor of indirect regulation only but we wish to stress that it's not just the banking system that needs to be "insulated". We see much merit in investigating which risks for the real economy, issuers and investors are caused by hedge funds, prime brokers and banks as a result of imprudent behaviour.

***5) Do prudential authorities have the tools to monitor effectively exposures of the core financial system to hedge funds, or the contribution of hedge funds to asset price movements? If not, what types of information about hedge funds do prudential authorities need and how can it be provided?***

We strongly welcome the striving for more transparency. Transparency has since long been demanded from issuers. It is widely held that efficient capital markets are best served with transparency. This assumption has led to very strict transparency requirements for issuers but until today those have not extended to other market participants. On the contrary, transparency has long been shied away from or even impeded by other market participants. The basis for the wish for more transparency is the assumption that investors should have all relevant information for their decision to invest or divest, these decisions thus leading to the most truthful and realistic market price.

Applying this idea to the financial markets it seems evident and inevitable that transparency should cover all market participants and also and especially hedge funds. A price is the result of supply and demand. The Commission Regulation (EC) No 2273/2003 of 22 December 2003 as regards exemptions for buy-back programs and stabilisation of financial instruments and the Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) are based on the findings that a company could manipulate the market price if a buy back programme covers more than 25 % of trading on any day. Applying this finding to hedge funds it is evident that hedge fund trading not only influences the market price but makes the market price. The consultation itself very rightly states that more than 50 % of market trades are done by or on behalf of hedge funds. The market price is thus not determined by the intrinsic value of the company and thus by those elements that are already subject to extensive transparency requirements, but by other factors which are foreign to the company and their owners who are long time investors. The consequence of this being that these investors will suffer a loss (or make a profit) when they want to sell their holding as a result of the actions of people who disregard the very reason for the existence of the company, namely the common purpose to earn money through the company's business. Considering this, a long time investor may lose out on every single trade conducted by a hedge fund. This could seriously affect the willingness of investors to make long time investments and provide stable funding for the business of the company, thus damaging the real economy.

The conclusion of the above should be more transparency requirements for hedge funds in order to give all market participants the relevant information to reflect on their investment behaviour thus leading to the most efficient markets and a fair and truthful pricing. This could for instance be effectuated by a set-up of a comprehensive data base, controlled by a competent authority on a day to day basis. Every hedge fund manager would report necessary data into this data base in order to increase financial transparency. These data would include information about the administrator, performance, size of the company, assets under management, location of the company, number of employees, the kind of hedge fund (single vs. fund of funds), the kind of strategy pursued and the trades in any security traded on a European market.

Now how could the above information be disclosed to the market in an appropriate manner? The hedge funds would probably be against a broad disclosure arguing that they could not reveal to the public (and therefore to the competition) their investment strategy and their methods. The hedge funds might also be concerned that disclosure of all their short positions might lead to such information being abused by a competitor. Knowing that company A holds a substantial short position in a security, company B (a competitor) might try to induce the price appreciation of that same security (e.g. by purchasing it) potentially leading to losses causing the insolvency of company A. Some might even argue that extensive disclosure (past performances, fund size, investment objective and strategy, structure and key employees of the fund) to all market participants could be considered as a marketing tool in seeking new investors. This in contravention of applicable restrictions (in order to be exempted from regulation).

Therefore we would propose that the disclosure to the market would be on an aggregated basis for all hedge fund positions in a given security. Thus no individual hedge fund would be singled out.

Again hedge funds could oppose to this kind of disclosure claiming that it could backfire, ultimately leading to further market disruption and volatility, as a consequence of market participants tending to mirror investment decisions made by so called seasoned and knowledgeable investors. That's why we believe that the market participants should know who are behind these positions so that they can form an idea on what were the motives for the said positions.

These considerations should be seriously reflected on by the legislator when looking for appropriate solutions. **We don't have ready made solutions: the matter is too complex and requires attention by experts who are very knowledgeable on the topic but who are also highly objective and take into account all interests, including those of the companies that are the subject of the investments. It is very well possible that solutions that could be satisfactory in normal circumstances for traditional market participants might turn out to be inadequate. Such MUST NOT make the legislator refrain from action, but encourage him to think out-of-the-box in looking for solutions.**

### **3. MARKET EFFICIENCY AND INTEGRITY**

***6) Has the recent reduction in hedge fund trading (due to reduced assets and leverage, and short-selling restrictions), affected the efficiency of financial markets? Has it led to better/worse price formation and trading conditions?***

As stated above there is very limited transparency on hedge fund activities in the capital markets. The recent increase in ask/bid spreads is probably the result of a general drop in funds available to all market participants. There is no evidence that it is caused by a decrease in hedge fund trading.

Increased market transparency in general would be very useful in order to gain more knowledge on the functioning of capital markets. This would be most helpful for governments and regulators when they fight a crisis.

***7) Are there situations where short selling can lead to distorted price signals and where restrictions on short selling might be warranted?***

and

***8) Are there circumstances in which short-selling can threaten the integrity or stability of financial markets? In combating these practices, does it make sense to tighten controls on hedge funds, in particular, as opposed to general tightening of market abuse disciplines?***

We also refer to what we stated above on the inappropriate pricing of securities due to certain hedge fund practices. As issuers we tend to distinguish at least two different circumstances for short selling: (a) short selling which uses misinformation or market

manipulation attempts or other factors or information not originating from the company, and (b) short selling based on the short sellers own assessment of market imbalances. It may be very difficult to regulate the former while not regulating the latter directly. Again we would advocate better transparency with respect to short positions in line with market rules to provide a very efficient corrective mechanism for market inefficiencies. Again we need to draw attention to the side effects of such transparency.

In any case the spreading of incorrect information should be made a criminal offense and prosecuted more effectively than is the case today. Such spreading of false information can cause serious losses to honest investors and seriously harm issuing companies. It must not be treated more lightly than inaccurate information from the company. Everybody who spreads such incorrect information should be liable to other market participants, shareholders and investee companies who suffer losses as a result of such market misinformation.

#### **4. MANAGEMENT OF MICRO-PRUDENTIAL RISKS**

***9) How should the internal processes of hedge funds be improved, particularly with respect to risk management? How should an appropriate regulatory initiative be designed to complement and reinforce industry codes to address risk management and administration?***

Every hedge fund manager should have an independent administrator in order to provide a safety net regarding asset valuation. Apart from that hedge fund managers should not be allowed to act as a principal of the client's assets. The relationship between the client and hedge fund manager should always be a principal-agency relationship, with the hedge fund manager as an agent.

One important aspect of risk management is also to make segregated accounts mandatory. Investors in hedge funds encountering problems may have great difficulties to recover their investments, which is even more difficult if hedge funds use omnibus accounts for their placements. Such omnibus accounts may cause legal obstacles for recovery of the hedge funds assets. It should be considered to oblige hedge funds to place all their assets in segregated accounts in order to mitigate risks.

In order to improve corporate governance, an independent board of directors might be helpful in providing genuine, active oversight in two key areas: portfolio evaluation and situations in which funds elect to impose gates or suspend redemptions. Again we would like to draw the attention of the regulators to focus on harmonised international standards in order to guarantee a level playing field.

We also strongly advocate that hedge funds have to comply with the same set of accounting rules as other professional investors and that no off shore vehicles could be used in order to hide investments, liabilities or other risks.

## **5. TRANSPARENCY TOWARDS INVESTORS AND INVESTOR PROTECTION**

***10) Do investors receive sufficient information from hedge funds on a pre-contractual and ongoing basis to make sound investment decisions? If not, where do the deficiencies lie? What regulatory response if any is needed to complement industry codes to make a significant contribution to the transparency of hedge fund activities to their investors?***

We are of the opinion that institutional investors, especially investors who act in the interest of third parties, should have the know-how to do the right assessment about future investments, particularly the risk assessment. That said, if an investor does not receive enough information to conduct a proper assessment, he should not place his money in it. Experience shows that a normal prudent and professional investor in this asset class should always have enough data to do sound investments in hedge funds. A normal hedge fund manager would provide any information an institutional investor needs.

But this does not apply to fund offering documents which very often lack the level of detail required under European regulations for other investments. Investors and regulators should require greater specificity in fund offering documents.

We observe that the Consultation Paper focuses on transparency towards investors and market participants. We find it utterly necessary to stress again that the “relationship” between the hedge fund and the companies whose shares it acquires or owns should not be neglected. From an issuer perspective it is very important that hedge funds act in a responsible manner with respect to their investment target. We would therefore also recommend that hedge funds should increase the transparency of their voting policy. This would on the one hand help the (private) end-investors to get informed on the strategies of the vehicles. On the other hand, portfolio companies could better anticipate potential conflicts and could enter into open discussions with the investors on essential points.

This dialogue requires that the issuer knows who his shareholders are. This is unfortunately – especially when it comes to hedge funds with a domicile abroad – often not the case. Therefore, as we have been asking again and again, we absolutely need a „system of EU-wide shareholder identification“. We refer in this respect to the European Parliament report with recommendations to the Commission on transparency of institutional investors (so called “Lehne report”)<sup>1</sup>. Any system of EU-wide shareholder identification should ensure that possible national mechanisms and national legislation relating to shareholder identification could be enforced also in other European countries.

***11) In light of recent developments, do you consider it a positive development to facilitate the access of retail investors, subject to appropriate controls, to hedge fund exposures?***

As issuers we do not consider this a positive development. We believe retail investors do not receive sufficient information from hedge funds and fund manager to arrive at a well

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<sup>1</sup> European Parliament report with recommendations to the Commission on transparency of institutional investors (A6-0296-2008) [‘Lehne’ report].

pondered investment decision with respect to hedge fund investments. This belief has been strengthened by recent developments.

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