

European Commission Consultation on Hedge Funds: response by HM Treasury and the Financial Services Authority (the UK Authorities)

January 2009



HM TREASURY



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Introduction and summary

1.1 The UK authorities welcome the Commission's attention to this important issue. Recent events demand a comprehensive reassessment of the global regulatory architecture for financial services. In our role as holder of the G20 Presidency, we are committed to working closely with international partners to deliver progress on this agenda. While hedge fund activity (either in Europe or elsewhere) has not been shown to have contributed significantly to the recent turmoil in global financial markets, it is nonetheless right to reassess our regulatory approach to hedge funds and their managers. As the location for around 80 per cent of the EU's hedge fund management business by assets under management, this is an issue of particular importance for the UK, and as part of our on-going vigilance in this area, the UK authorities are already re-examining our regulatory approach in light of the financial crisis.

1.2 In particular, we believe there is a case for doing more to ensure oversight of all entities which could contribute to macroprudential risk – achieving this is likely to require an extension of our oversight not only of hedge fund managers but also potentially of other types of entity. This work is still at an early stage and we are not yet able to provide detailed proposals. However, we believe that international co-operation will be essential to addressing these issues effectively and plan to work closely with our partners in the EU and G20 as we develop these plans.

1.3 Nonetheless, while acknowledging the importance of a reassessment of policy in this area, we believe it is also vitally important to avoid allowing high-profile political debate around hedge funds to obscure more fundamental issues. While hedge funds do possess a relatively unique combination of characteristics, the individual risks they pose are not unique. For example, while the solvency of a bank could indeed be compromised by unexpected losses on lending to hedge funds, bank solvency can be compromised by unexpected losses on lending to any institution or group of individuals – the central stability issue here is not hedge funds but bank credit risk management across the board. Other risks highlighted in the consultation document – for example market abuse or rapid deleveraging – also apply to all other market participants. A regulatory response to these risks which focused on hedge funds alone would not be effective and would create opportunities for regulatory arbitrage. So while we agree that a re-examination of the EU regulatory framework that applies both to hedge funds and hedge fund managers is appropriate, we do not believe that EU legislation aimed at hedge fund activity alone is likely to be the right means to deliver the necessary improvements.

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Responses to questions

Question 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?

2.1 Hedge funds are notoriously difficult to define, but this description does effectively identify their principal characteristics. Regarding leverage, however, there are two points we feel should be noted. First, while it is true that hedge funds do generally enjoy the flexibility to employ high levels of leverage, a significant number employ little or none. Secondly, while it is true that some hedge funds are relatively highly leveraged compared to traditional investment funds, average leverage for the sector as a whole is generally thought to be between 1.3x and 1.7x. This is significantly lower level of leverage than, for example, banks.

2.2 More generally, we believe it is important for policymakers to acknowledge that many aspects of hedge fund behaviour are shared by other market participants. As regards their role in the market, hedge funds are subject to MiFID, the Transparency Directive and the Market Abuse Directive (like other market participants) and if they were to become members of trading systems (Regulated Markets or Multilateral Trading Facilities) they would also be subject to the rules of that platform.

2.3 The UK authorities draw two conclusions from this. First, it is not accurate to regard this as an unregulated sector. Second, given the above, it is important to clarify what exactly about hedge fund behaviour gives rise to concerns (since banks and other market participants display some of the same characteristics). In order to preserve the balance in our capital markets and to have equivalent rules for all, if we are concerned about short-selling or market abuse for instance, we should debate their regulation at a market-wide level, not for a specific category of market participant while not applying the same logic to other entities doing the same thing. The combined characteristics of hedge funds are relatively unique, but each of the individual aspects is shared by other market participants. So while no other major class of entity displays the combination of leverage, complex and flexible trading strategies etc of hedge funds, there is no single aspect of hedge fund behaviour which is unique to that sector. We believe that a targeted assessment in sum of the regulatory response to hedge funds is justified but, given many of the risks posed by hedge funds are also posed by other institutions, that regulatory interventions focused specifically on the sector are unlikely to be effective.

Question 2

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

2.4 No – while it is of course vital that the EU and its Member States ensure an effective regulatory response to all financial risks, hedge funds are clearly a global issue. It is important to note that none of the high-profile hedge fund failures which have served to draw public attention to these issues – for example Long-Term Capital Management, Amaranth, and others – has involved an EU-based hedge fund manager. While this can be no cause for complacency, it does suggest that authorisation and supervision of hedge fund managers (which is compulsory in the UK and other major EU markets but not in the US) has been effective in mitigating the risks of hedge funds. It also suggests that there would be real risks to a heavy-handed EU response which was not matched by action elsewhere, since the net result could be simply to drive business away from the EU to other less regulated jurisdictions, while still having to deal with the impacts of their behaviour in European markets.

2.5 The G20 has committed to further work in this area and we would not support any substantial EU-only action before the direction of this work is clear.

Question 3

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

2.6 As the document notes, it has traditionally been thought that the most likely means through which a hedge fund failure could spill over into wider markets would be the consequent failure of a prime broker. Regulators and prime brokers have both devoted significant resources to mitigating that risk since the near-failure of Long-Term Capital Management in 1998. Recent events have provided a severe stress test of this risk management framework. We have seen a large number of hedge fund failures at a time when many banks' capital bases were already under extraordinary strain. At this stage, it appears that the risk management framework was equal to this test – while some banks have failed and many others have been forced to recapitalise, in no instance do losses on lending to hedge funds appear to have been a significant contributory factor. It therefore appears that, in this area at least, the lesson we can draw from recent events on the effectiveness of regulatory and market safeguards is a guardedly positive one.

2.7 Concerning the risks from hedge fund deleveraging, it is clear that this process has put downward pressure on already falling asset prices in recent months. The volume of the reduction of hedge funds' total long positions has been very large. Estimates vary widely, but assuming a total fall in client assets under management from \$1.9 trillion to \$1.1 trillion and a fall in average leverage from 1.8x to 1.3x, there could have been a total fall in long positions of as much as \$2 trillion (€1.5 trillion). While some of this will have been the result of falling asset values rather than disposals, this still represents a very large net disposal.

2.8 However, it is also important to note that hedge funds are far from being the only investors who have liquidated positions. The contraction in banks' balance sheets has been many times that of hedge funds. Equally, where markets have suffered acute stress – for example the freezing of structured credit markets – this seems to have been driven by sudden shifts in market sentiment across the board rather than withdrawal of liquidity by any particular group of investors.

Question 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?

2.9 The term 'indirect regulation' can be rather misleading. When the risk in question is that the solvency of a bank may be compromised by losses on its lending or exposure to hedge funds, it is hard to see how prudential regulation of those banks could be termed an 'indirect approach'. In no other area of bank lending is the idea of regulating the banks' creditors in order to protect the solvency of the bank given serious credence. Seeking to mitigate what is essentially a banking credit risk by regulating the borrowers could be a dangerous distraction. Regulators must not do anything to dilute the fundamental principle that effective credit risk management is the responsibility of banks themselves.

2.10 In all areas of banking credit provision it is vital that banks make robust assessments of credit risk and set aside enough capital to allow them to absorb reasonably foreseeable losses. In order to ensure this happens with banks' exposures to hedge funds, regulators and banks themselves have worked hard to drive the development of robust risk management processes. In line with the recommendations of the Financial Stability Forum in May 2007¹, the UK authorities have been working closely with global counterparts to push banks to make further improvements in this area and will continue to do so.

Question 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?

2.11 We believe that recent events have shown the importance of ensuring effective oversight of all entities which contribute to macroprudential risk. This is likely to require enhanced oversight of hedge funds but may also require action in respect of other sectors. This would be likely to include data collection by supervisors on hedge fund leverage and high-level investment strategy. If the data collection exercise was properly specified and the results were properly used, this could help regulators in identifying concentrations of risk in particular sub-sectors of markets.

2.12 However, it is also important to note the risks of this sort of approach. When supervisors collect data, it creates an impression in the market of oversight of the associated risks. This could act as a signal to market participants to reduce the resources they themselves devote to risk management. And if the supervisor is in fact unable to perform the kind of oversight assumed by the market risks may go unmonitored. It will therefore be vital in any increase in data collection to ensure i) that data is only collected where supervisors have identified a clear use for it in mitigating a particular risk; and ii) that supervisors make clear that oversight by them can be no substitute for proper risk management by firms.

¹ http://www.fsforum.org/publications/r_0705.htm

2.13 As noted above, the UK authorities are still developing a more detailed position on this issue and are keen to work with the Commission and other international partners to find the right approach.

Question 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?

2.14 It is not easy to isolate a marked decrease (or increase) in hedge fund activity in assessing trends and changes in market efficiency. Hedge funds have been important contributors of trading liquidity in recent years and the reduction in this activity and greater caution by other market users has seen lower levels of activity in many markets. While this has tended to widen bid-ask spreads and reduce the depth of liquidity, it is difficult to assess how far the rapidly changing circumstances of hedge funds, which may have led to a need to unwind short, long and complex positions across asset classes, have contributed to the exceptionally high levels of volatility in many financial instruments in recent months.

Question 7

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

2.15 Short selling can be used abusively to create misleading signals about the real supply, or the correct valuation, of a stock and/or 'scaremongering' to push down the price of a stock being shorted. Small cap/illiquid stocks can be particularly vulnerable to this type of manipulation by short selling. Often this is an unprofitable strategy in that borrowing the stock is usually relatively costly. However, because the behaviour of a small cap stock is far more stock-specific i.e. dependent on information flow related to the stock rather than the market as a whole, it is possible, by aggressive short-selling, to give the market the impression that a significant, but as yet unrevealed, piece of information is impacting on the price. In summary, the short-seller attempts to provide the market with a misleading signal. The signal is misleading because this is not a standard sale of stock; the seller intends to buy back the stock at a lower price. Not knowing this, other market participants sell in response to the price move, forcing the price down further, perhaps hitting stop-loss points triggering further falls. The short-seller then covers the position locking in a profit. This strategy may be supported in the market by generating false rumours.

2.16 However, it is important to note that it is the market abuse – and not the long or short nature of a trade – which would result in the abusive distortion of prices. Wherever possible, the supervisory response to market abuse should be detection of and enforcement action against the market abuse itself, regardless of who actually commits the abuse. Short selling can be used as a mechanism to execute abusive trading strategies but so can the taking of long positions. We already have powers under the Market Abuse Directive to pursue market distortion or spreading of false and misleading information and would therefore not generally see a case for restricting short selling, which we regard in normal market conditions as a legitimate trading technique. However, see the answer to question 8 below. We also note that we do see a case for increased transparency regarding short selling and will be publishing our ideas for achieving this shortly.

Question 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?

2.17 Firms whose existence depends on the confidence of their customers and counterparties in the stability of the institution (e.g. financial sector companies) may be particularly susceptible to market manipulation through aggressive short selling, especially in a climate of severe market turbulence and uncertainty. It was our view that market conditions in the autumn of last year led to a heightened (and unacceptable) risk of abusive behaviour and resultant disorderly markets through short selling. The risk was that heavy falls in the share prices of a financial institution might prompt creditors to withdraw funds from the institution threatening to destabilize it. This was the reason for the emergency measures we took in September prohibiting the creation or increase of net short positions in UK financial sector stocks. This prohibition has now been allowed to expire but we would be prepared to reinstate it if we thought it necessary.

2.18 However, it is important to note that short selling is not specifically a hedge fund issue. It is a tool employed by many other market players and if restrictions are to be imposed it makes no sense to limit their application just to hedge funds. The potential market impact of a hedge fund trade is no larger or smaller than that of the same trade made by any other market participant.

Question 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?

2.19 The CRD applies to most hedge fund managers in the UK (except, for instance, UCITS firms) and this requires differential capital to be set against the risks that the manager is exposed to, in order to be able to effect an orderly winding up if necessary. In general terms, we find that the quality of risk management in hedge fund managers exceeds that of other market participants (e.g. prime brokers). While improvement to risk management is clearly an important challenge for the financial services industry as a whole, performance during the financial markets crisis has done nothing to indicate weaknesses in this area which are specific to hedge funds.

2.20 As a key part of its supervision of hedge fund managers within the UK regime, the FSA focuses on their risk management practices. Furthermore, regulatory authorities are likely to consider examination of risk management in the work they undertake in the wake of the Madoff scandal.

Question 10

(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?

2.21 There are certain minimum aspects of disclosure which it is unambiguously in the interests of hedge fund investors to receive. One example is the existence of material side letters. The FSA requires disclosure of these and has approved best practice guidance by the Alternative Investment Management Association on the issue. However, it would not be appropriate to try to set out general detailed requirements for disclosure for two reasons. Firstly because the strategies of hedge funds, and therefore the most useful level and form of disclosure, vary so widely – daily portfolio transparency would be of little use with a fund which focused on longer-term shareholder activism but might be considered essential by investors in a fund which traded much more frequently. And secondly because the selling of hedge funds should be restricted to those expert and professional investors who are sophisticated enough themselves to decide on and demand an appropriate level of specific disclosure for the fund in question.

Question 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?

2.22 Hedge funds which are not subject to regulatory controls on their investment strategies are not suitable for direct sale to retail investors who do not in general have the necessary expertise to understand the risks and costs involved. However, there is a case for allowing retail access via funds of funds provided effective disclosure, diversification and risk management can be assured. In the UK, the FSA has consulted on introducing precisely such a regime.

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