



31 January 2009

EFRP Response

European Commission Consultation on Hedge Funds

Identification of Response

The **European Federation for Retirement Provision (EFRP)** represents the various national associations of pension funds and similar institutions for supplementary/occupational pension provision. Its membership at large consists of institutions for workplace (2nd pillar) retirement. Some of them are also operating purely individual pension schemes (3rd pillar).

The EFRP has **28 members associations** in most EU-15 Member States and other European countries that have a significant – in size and relevance – workplace pension system¹

Within EFRP the **Central & Eastern European Countries Forum (CEEC Forum)** has been established (26 October 2006) to discuss issues common to pension systems in that region. The CEEC Forum has not expressed its view on this consultation as such since there are no IORPs operating in the CEEC region as focussed on by this consultation.

83 million EU citizens are covered for their workplace pension plan by EFRP Members. Through its Member Associations the EFRP represents approximately **3,5 trillion of assets (2007) managed** for future occupational pension payments.

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¹ EU Member States: Austria, Belgium, Finland, France, Germany, Hungary, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Slovakia, Sweden, UK.
Non-EU Member States: Croatia, Guernsey, Iceland, Norway, Switzerland.

General comments

1. EFRP welcomes the opportunity to respond to the European Commission's "consultation paper on hedge funds". It regrets having to say that the consultation period – including a seasonal break – is too short to conduct a fully fledged consultation among its members.
2. The consultation paper rightly identifies IORPs – more commonly referred to as pension funds – as hedge fund investors. Assets under management of European pension funds amount to 2,880 billion euros ultimo 2007. No more reliable recent data are available as the financial turmoil makes every attempt for extrapolation a vain exercise.
3. IORPs have increased their portfolio allocations to hedge funds in recent years, but investments in this asset class are still at relatively low levels. According to an OECD survey, **investments in hedge funds now range from 0-3%** in twelve European countries.² Larger pension funds – having sophisticated back office support in their investment departments – tend to have more direct hedge fund exposure, while smaller pension funds are more reliant on so-called fund of funds.
4. The subject of hedge fund regulation is of considerable interest to IORPs and their stakeholders:
 - Hedge funds play a crucial role in financial markets by **providing liquidity and efficient pricing** of financial instruments. This is beneficial to IORPs as they are an important actor on financial markets.
 - Hedge funds **improve the risk-return characteristics** of the investment portfolio of IORPs by enhancing diversification. Hedge funds provide for attractive absolute returns with low volatility and little correlation with other asset classes. Moreover, hedge funds appear to be a good hedge against inflation risk by aiming for absolute returns in excess of the short-term interest rate (which is strongly correlated with inflation).³
 - Hedge fund strategies make extensive use of short-selling. Pension funds benefit from these short selling activities in a direct way as they are a **prime source of securities lending** to hedge funds.

² Fiona STEWART, Pension Fund Investment in Hedge Funds, OECD Working Papers on Insurance and Private Pensions, No. 12, 2007, OECD, Paris.

³ Roy HOEVENAARS, Roderick MOLENAAR, Peter SCHOTMAN and Tom STEENKAMP, Strategic asset allocation with liabilities: beyond stocks and bonds, Journal of Economic Dynamics and Control, 2007.

5. IORPs have a clear interest in well functioning financial markets. The sharp fall in asset prices has triggered lower funding ratios (DB plans) and lower capital values on individual accounts (DC schemes). This potentially translates into higher contribution rates and/or lower retirement benefits and, hence, has negative consequences for European industry and households. In this respect, we attach great importance to an adequate financial services regulatory framework. However, at the same time **EFRP warns against the danger of rushing into ill-considered regulation.**
6. Hedge funds depend on their prime broker for the financing of their leveraged positions. Through this channel a hedge fund failure might negatively affect the banking system and jeopardize financial stability. However, in our view this risk is mitigated most efficiently and effectively by **keeping in place the existing system of indirect regulation through financial institutions with systemic relevance.** Additionally, it is unlikely that the unwinding of some hedge funds significantly aggravated the fall in overall asset prices, since most hedge fund strategies have low net exposure to financial markets.
7. The issue with hedge funds and their managers is the opacity with respect to strategy and performance, valuation, risk management, internal operations and possible conflicts of interest. The hedge fund industry and supervisors have addressed this issue by developing standards for hedge fund managers and investors.⁴ Hedge funds are an asset class for professional investors. Any hard regulation in this area would deviate from the established legislative assumption that **professional investors have the capabilities and resources to make informed investment decisions.**
8. In this respect **EFRP is sympathetic towards the approach taken by the G20** to first assess the adequacy of the proposals for best practices put forward by the industry. If the Commission decides on additional regulatory actions a joint response with the United States will be inevitable given the global nature of hedge fund activity. The regulatory initiatives would best elaborate on the best practices developed by IOSCO and the industry. This also means that regulations should be targeted at hedge fund managers to avoid unintended spillovers to other sorts of investment funds.

⁴ See for instance Asset Managers's Committee, Best Practices for the Hedge Fund Industry, Report of the Asset Managers's Committee, 15 January 2009, www.amaicmte.org, Hedge Fund Working Group, Hedge Fund Standards: Final Report, January 2008, www.hfsb.org, IOSCO, Principles for the Valuation of Hedge Fund Portfolio, Report of the Technical Committee, November 2007, www.iosco.org, IOSCO, Report on Funds of Hedge Funds, Report of the Technical Committee, June 2008, www.iosco.org.

9. Apart from providing liquidity to financial markets, hedge funds also enhance diversification possibilities of institutional investors, of which EFRP considers itself to be a representative (see item 4 supra). Better investment opportunities mean that IORPs can **provide plan members with higher retirement benefits at lower risk**. These advantages should in the opinion of EFRP not be put into jeopardy by over-regulation of the hedge fund industry.

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?*

The three characteristics give a general description of the hedge fund industry, but necessarily remain rather vague as consequence of the **large diversity of hedge funds**. Absolute returns seem to suggest that there is no exposure to market risk. However, some hedge funds employ directional strategies – global macro, short selling – that imply a substantial sensitivity of returns to financial market developments.⁵ There are also vast differences in the degree of leverage used by hedge funds. Leverage may range from two times capital for equity long-short funds to ten times capital for fixed-income arbitrage funds.⁶ It is not clear what a relatively high leverage means as, for instance, banks often employ leverage of 15 times and insurers of 7½ time shareholders' equity.

The three considerations are not sufficient to distinguish hedge funds from other actors. For instance, it may also apply to a non-regulated investment fund making use of options or futures for hedging purposes. Such derivative contracts often feature an element of borrowing or leverage.

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

It is self-evident that an initiative confined to EU-based hedge funds would be ineffective in a globalized world with free movement of capital. Too stringent regulations would encourage hedge funds to serve their clients from another location outside the European Union. Especially the hedge fund industry has proven itself to be very innovative and flexible in finding the most attractive

⁵ See for a comprehensive overview of hedge fund strategies Filippo STEFANINI, *Investment Strategies of Hedge Funds*, 2006, John Wiley, Chichester

⁶ International Monetary Fund, *Global Financial Stability Report – Financial Stress and Deleveraging Macro-Financial Implications and Policy*, October 2008, Washington DC.

locations. For instance, many European hedge funds are managed from London, administrated from Ireland and domiciled in offshore locations like the Cayman Islands, the British Virgin Islands and Bermuda.⁷ The international nature of hedge fund activity suggests that indirect regulation through their investor base might be more effective.

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

EFRP agrees that the most direct risk of hedge funds to the wider financial system is through the counterparty exposure of banks/prime brokers (see answer to Question 4). The case of LTCM illustrates that a hedge fund failure may result in substantial write-offs for banks.

The **pro-cyclical impact on financial markets through the channel of hedge funds unwinding asset positions has probably not been very significant** as the net market exposure of hedge funds is limited. Liquidating a long-short equity fund means that equities have to be sold. However, at the same time the short position has to be unwound, which involves the buying of equities.

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?*

Hedge funds have not been at the root of the financial crisis, but rather have been hit by the effects of the turmoil such as the low liquidity, tough borrowing conditions and the flight to safety by investors. EFRP feels there is insufficient evidence to revise the present regulatory approach to hedge funds, namely indirect regulation.

It is most efficient to **keep targeting prudential regulation to financial institutions that are ultimately most relevant for systemic risk**. Most notably, this is the banking sector that is very sensitive to adverse financial shocks and plays a crucial role in the proper functioning of the economy. So, prudential regulations should focus on the exposure of such financial institutions to hedge funds. This would prevent a complicated and expensive regulatory system with double levels of supervision. Moreover, **direct regulation would not be effective without a comprehensive global regulatory framework** as hedge funds can easily move to another country around the globe.

⁷ European Commission, Report of the Alternative Investment Expert Group – Managing, Servicing and Marketing Hedge Funds in Europe, July 2006, Brussels.

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?*

Prudential authorities are supervising the banking and insurance sector and through this channel they are able to monitor the exposure of the core financial system to hedge funds. Supervisors must ensure that exposure to hedge funds is sufficiently collateralized and that proper risk management systems are in place. Supervisors must also demand disclosure of hedge fund positions including the magnitude of leverage, short selling and liquidity. Finally, authorities might want to look at the hedge fund management and the proper segregation of assets.

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?*

EFRP agrees with the consultation paper that hedge fund activity is beneficial to the functioning of financial markets. Hedge funds are very active traders and hence make a significant contribution to **liquidity of financial markets**. Liquidity is beneficial to other market participants as it allows them to buy and sell financial instruments easily and at relatively low costs. Moreover, hedge fund strategies try to exploit perceived mispricings and, by doing so, improve price formation and **efficiency of financial markets**. Hedge funds also contribute to financial market integration as they do not restrict themselves to specific market segments.⁸

Difficulties to raise funding, redemptions by investors and the short-selling bans imposed by some governments have reduced hedge fund activity. This may have **contributed to the poor functioning of financial markets** and their lack of liquidity.

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

EFRP feels that short-selling is essential to the well-functioning of financial markets. Short-selling may be misused by some market participants, but this does not justify a prohibition of short-selling. The costs in terms of less liquid and less efficient markets will undoubtedly be higher than the benefits as market abuse can be combated by other means (see also the answer to Question 8).

⁸ Tomas GARBARAVICIUS and Frank DIERICK, Hedge Funds and their Implications for Financial Stability, ECB Occasional Paper Series No. 34, August 2005, Frankfurt.

Short-selling is said to have originated exactly four hundred years ago and since then states have frequently imposed and lifted bans on short selling.⁹ In this respect the recent crisis has not been different as many governments again decided to (temporarily) prohibit the practice of short-selling. The restrictions on short-selling mainly focussed on shares of financial institutions.

It should first be emphasized that **short-selling did not contribute to the overall fall in equity markets** in the past year. Hedge funds with pure short-selling strategies cover only a marginal fraction of the hedge fund universe and the capitalization of world stock markets.¹⁰ A case can be made against short-selling of financial institutions in the context of the financial crisis. Banks and insurance companies face substantial liquidity problems and a decline of their share price may worsen these funding difficulties. However, recent research indicates that the short-selling bans have not been effective in limiting falls in share prices.¹¹

The negative impact of short-selling restrictions may be substantial as is illustrated by the following examples:

- Hedge funds aim to exploit relative mispricings in financial markets without being exposed to overall market risk. They hedge market risk – hence the name hedge fund – by offsetting a long position in some securities by a short position in other securities. Hedge funds are unable to execute such strategies if governments restrict short-selling and, hence, liquidity and efficiency of financial markets will be reduced.
- Many investors make use of derivative contracts to manage risk in their investment portfolios. For instance, investors might want to buy put options for protection against a fall in share prices. The counterparty selling the put option will want to hedge his exposure by taking a short position in the stock. This will be impossible in case of a short-selling ban and, hence, the functioning of derivatives market will be negatively affected.

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?*

⁹ See for a short history of short-selling Filippo STEFANINI, *Investment Strategies of Hedge Funds*, 2006, John Wiley, Chichester.

¹⁰ According to Filippo STEFANINI, *Investment Strategies of Hedge Funds*, 2006, John Wiley, Chichester pure short selling strategies accounted for only 0.24% of all hedge fund strategies and only 0.015% of US equity markets capitalization on 31 December 2004.

¹¹ See Ian MARSCH and Norman NIEMER, *The Impact of Short Sales Restrictions*, 30 November 2008, Cass Business School, London, www.cass.city.ac.uk.

It is the view of EFRP that **safeguarding integrity of financial markets should be dealt with through the Market Abuse Directive**. Market abuse is not confined to short selling, but affects all financial instruments. Of course, participants in financial markets can make profits by spreading negative rumours about a company and short selling the stock. But in the absence of short selling possibilities, these persons can attain the same result by buying put options or selling futures contracts. And malevolent people can also make illegal gains by buying equities and spreading positive rumours. Combating market abuse by restricting the use of certain financial instruments will come at substantial costs in terms of less liquid and less efficient markets.

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?*

Risk management systems of hedge funds have for long been regarded to be at the frontier of financial economics as hedge funds engage in very complex investment strategies. Innovations in risk management practices by hedge funds were believed to contribute to better risk management in other financial sectors.

It should be reminded that hedge funds must take on some risk to achieve absolute returns in excess of the risk-free interest rate. Moreover, sound risk management is not equivalent to a zero probability of something going wrong. The events that unfold during the current turmoil are quite exceptional. Not only hedge funds were negatively affected by strict borrowing standards, illiquid markets and a flight to safety, but also other institutions in other sectors.

Obviously, hedge funds exist that have poor risk management in place. For instance, the Madoff scandal could probably have been prevented by a clear separation of the manager, custodian and administration functions. The hedge fund industry has developed standards that will aid investors in identifying managers with sound risk management practices. If deemed necessary, regulations could be designed that elaborate on these best practices.

Question 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?*

Investing in a complex asset class like hedge funds requires an elaborate due diligence process. This would include an analysis of company policies, investment

history, references with respect to persons involved, dependency on specific portfolio managers, own funds invested by the managers, fee structure, alignment of interests, suitability of leverage, internal control procedures, risk management systems, valuation methods and independent supervision on accounting. Investors need also require hedge funds to be transparent about investment strategies, to frequently issue performance and risk reports and to allow for regular meetings with the portfolio managers to discuss the results. The professional investor should have a comprehensive performance measurement system at this disposal to assess whether hedge funds are truly adding value or merely are exposing themselves to market risk ('selling beta for alpha').¹²

It is the view of EFRP that **professional investors may be considered to have sufficient capabilities and resources** about making an informed decision about whether or not to invest in hedge funds. This principle also underlies European legislation like the Prospectus Directive and MiFID. The industry codes increase transparency of hedge funds and will help (professional) investors to identify well-managed hedge funds. If self-regulation is considered to be inadequate regulations could be developed that elaborate on the best practice set forth by the industry.

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?*

EFRP would **caution to facilitate direct access of retail investors to hedge funds**. Hedge funds are a very complex asset class that requires – as discussed in the previous question - extensive financial knowledge and resources. It is probably best to limit involvement of retail investors to so-called fund-of-funds, in which professional managers select and monitor appropriate hedge funds, while enhancing investor information at the level of the master fund. Retail distribution should be subject to strict protection rules, which inform retail investors on the risks involved. The funds itself could be regulated at the EU level by a UCITS type regime (by some referred to as alter-UCITS). Such a regime could also benefit professional investors that feel uncomfortable with investing in hedge funds directly.

¹² See Investors' Committee, Principles and best practices for hedge fund investors, Report of the Investors' Committee to the President's Working Group on Financial Markets, 15 January 2009, www.amaicmte.org.