Report of the Alternative Investment Expert Group

Managing, Servicing and Marketing Hedge Funds in Europe

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European Commission
Internal Market and Services DG

REPORT OF THE ALTERNATIVE INVESTMENT EXPERT GROUP TO THE EUROPEAN COMMISSION

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PREFACE

In July 2005 the European Commission launched a public debate on possible ways to enhance the European framework for investment funds. While the debate focuses primarily on retail investment funds that fall within the existing legislative framework (UCITS), the Commission also notes the strong growth of the alternative investment market, consisting of inter alia, private equity funds and hedge funds.

This report represents one of the first opportunities for a group of hedge fund practitioners (the "Group") to contribute to the policy debate on the development of this fast-moving business. This report is an opportunity for the industry to explain how it sees the challenges, identify areas for possible improvement and address preconceived notions about the hedge fund business.

The Commission invited the Group to report on how it sees the future development of the hedge fund industry in the European context, and whether there are any European-level regulatory or other obstacles which hold back the efficient organisation of the business in Europe.

In autumn 2006 the Commission intends to publish an investment fund strategy paper detailing the actions it proposes to take to facilitate the efficient development of the European funds sector. There may be an opportunity in that paper to consider elements of the approaches to alternative investment funds, including, inter alia, hedge funds. This report and, notably, the reactions to it will feed into the Commission's strategy paper and future policy reflections.

The Group also hopes that the analysis and associated recommendations in this report serve to fuel a wider debate on the successful development of alternative investments in the European context. The Group's members have on average about 17 years of experience in the investing and hedge funds in Europe. The Group wishes to contribute to ongoing reflections on the development of the policy framework for a vibrant European asset management business and to draw attention to areas for potential improvement in the European operating environment for hedge funds and funds of hedge funds.

The Group has now completed its report. This report reflects the outcome of the Group's discussions during the period February – June 2006. During that period, the Group met four times to discuss an evolving draft of this report. In the limited number of instances where points of view could not be reconciled, this is made clear in the body of the report. The report does not necessarily reflect the views of the organisations to which the group members belong.

The role of Commission staff in this process was to facilitate discussions – by providing secretarial support in organising and hosting the meetings, and acting as the chronicler of group discussions. This report represents a fair presentation of the views of the Group's members. It should not be construed as reflecting the views of the Commission or of its services.

The Commission services now wish to submit the assessment and views of the Group to wider scrutiny and open debate before developing a basis for a formal position. To this end, the Commission services have organised an Open Hearing in Brussels on 19th July 2006. Stakeholders are also invited to send their comments to the following address: markt-consult-july-2006expertgroups@ec.europa.eu by 20th September, 2006. These reactions will be published on the relevant website unless confidentiality is requested.

EXECUTIVE SUMMARY

Hedge funds have been active in financial markets for almost 60 years. In recent years, their scale and global reach have moved them to centre-stage. Hedge funds and funds of hedge funds now account for about $1.2 trillion under management worldwide.

The European Union is at the heart of this growing business. European hedge fund managers now manage $325 billion. Their customer base is broadening: hedge funds are no longer the preserve of high net worth individuals. Pension funds, life insurance companies and other institutional investors are increasingly looking to hedge funds to deliver attractive returns and portfolio diversification. Hedge funds – and derived products – are being made available to a wider investing public. Hedge fund assets are growing in size and hedge fund techniques are entering the mainstream. Hedge funds are forcing a 're-tooling' of the entire asset management business. Traditional asset managers are borrowing hedge fund techniques to deliver tailored combinations of risk and return to a wider range of investors, so that the distinction between "traditional" asset management and alternative investment is blurring.

The hedge fund business is maturing in a way that does not give rise to any need for additional specific or targeted legislation of hedge fund participants or investment strategies at a European level. The great majority of the participants based in EU countries (be they hedge fund managers, fund of hedge funds managers, prime brokers or fund administrators) are already effectively regulated in their varying jurisdictions. This is a business that has grown up on an international basis: funds or products domiciled in one jurisdiction are managed and serviced from another, for sale to clients in a third. The existing light-touch regulatory approach has, in the view of the Group, served the industry, its investors and the wider market well. It is suggested that additional regulation, which does not and arguably cannot accommodate the need for unrestricted investment freedom or the international organisation of business models, is likely to fail and will do little to further protect investors compared with the status quo. In particular, regulation of investment strategies is the very antithesis of the hedge fund business and would be misguided.

The Group calls on European regulatory authorities to adopt a policy of enlightened self-interest. This would recognise that attempts to further regulate this evolving industry will drive the business and its investors offshore or lead to the packaging of hedge fund based investments in other forms. Therefore, efforts to create a suitable regulatory environment in Europe should work within this concept of the market.

As the industry matures and the investor base broadens, many Member States have stepped up their regulatory engagement with this business. The Group welcomes this engagement and any dialogue which encourages greater understanding of the industry. The Group appreciates that public authorities have a legitimate interest in the activities of hedge funds – particularly to the extent that certain hedge fund products are sold to the retail market. Member State authorities have been building regulatory systems that can support well-supervised fund managers and soundly administered hedge funds. However, the Group submits that any regulatory evolution should be a proportionate response to demonstrable risks and take account of the specificities of this business.

This report identifies areas where carefully judged non-legislative steps at a European level could facilitate the further development of this business in a European context. It acknowledges the need to balance the interests of investors, as noted above, particularly retail investors, with those of the industry. The regulatory patchwork in the European Union limits the most efficient organisation and distribution of the hedge fund business. It results in a competitive environment for those seeking to invest in the European asset management industry that is fundamentally at odds with the goals of the European Union with regard to the development of the single market. In particular, in the European

Union where enormous efforts have been made to encourage the free movement of capital and services, continued uncertainty regarding the conditions under which distribution can be undertaken stands in the way of this objective. It drives investors, who can contract with a hedge fund manager under the law of another jurisdiction, offshore. It prevents the development of a scalable onshore business. It results in inefficiencies in managing and administering portfolios, and in providing support services to the industry. All of this ultimately adds up to higher costs and reduced access for investors. If the European Union wishes to be home to a successful hedge fund business, it should take steps to remove these frictions.

The Group has agreed a set of targeted and practical recommendations which it believes are important for the continued successful development of the hedge fund business in Europe. These recommendations should not be viewed as a pretext for heavy regulatory involvement in this business, or in particular, for introducing product regulation. The proposed adjustments do not, in the Group's view, require extensive legislative harmonisation. These adjustments would facilitate the further successful development of the business without compromising regulatory objectives of retail investor protection or market integrity.

The recommendations all relate to two key areas:

- Freeing up access to investors in other Member States by removing unproductive, inefficient and unjustified legal or regulatory impediments; and

- Removing and not creating barriers to the free provision of services between Member States, which impedes access to "best of breed" service providers for essential support services such as fund administration, custody and prime brokerage.

Freeing up access to cross-border investors:

There is a growing demand from investors for access to hedge funds. Investors increasingly understand that there is a place for hedge fund investments in a properly diversified portfolio. This demand is no longer restricted to professional or institutional investors. It includes high net worth and in some instances retail investors seeking a wider range of investment opportunities than those offered by traditional equity investments. The hedge fund industry is well equipped to respond to this demand. Institutionalisation of the hedge fund industry is driving increased transparency, better valuations and risk management. The hedge fund industry wishes to service this changing investor base as efficiently as possible. It would like to do so from established platforms and centres of excellence which benefit from economies of scale and the development of the best management expertise. The industry will not develop efficiently if required to build a local management presence or fund administration centre in each target market. Nor is it reasonable to place the additional cost burden of such a national infrastructure on investors. As the industry develops, the restrictions on cross-border marketing and portfolio construction are proving increasingly costly in terms of foregone opportunities, legal uncertainty and compliance costs. These are increasingly hard to justify when the success of hedge funds is a matter of record. A further consideration is that well-intentioned national rules merely succeed in pushing investors to obtain hedge fund access through other means, such as acquiring hedge fund exposure through structured products, shares in closed-end funds or investing offshore.

The Group believes that it is time to move on. Recent regulatory developments within the European Union provide an opportunity for a fresh look at arrangements governing the Europe-wide distribution of hedge funds. These developments could overcome unnecessary obstacles to cross-border placement of hedge funds with qualified investors who are capable of self-directed investment.

The Group calls for a rational and dispassionate debate on the conditions under which retail access to hedge fund-based investments could be contemplated. Retail investor access to appropriately marketed hedge fund-based investments should no longer be taboo.

1: Member States should recognise the broadening investor appetite for hedge funds and related products by developing a regulatory approach that is compatible with these needs and the organisation of the hedge fund business.

The Group recommends that European authorities and supervisors allow the provision of investment services in respect of the full range of hedge funds and related products by investment firms authorised in accordance with MiFID – without imposing additional restrictions or formalities at the level of the fund, its manager or other participants in the value chain.

In particular, the Group recommends that regulators do not seek to control sales and distribution through product regulation or registration. The Group is of the view that regulators should focus, instead, on two levels of protection:

- **First, the Group recommends that conditions be introduced to prevent access to hedge funds by investors for whom such investments are not suitable. A majority of Group members considered a minimum threshold of 50'000€ would satisfy this condition. A substantial minority considered that a higher threshold and/or other safeguards should apply; and**

- **Second, the Group recommends the enforcing of clear conduct of business requirements on the intermediaries and institutions who conclude sales contracts with end-investors. This is an appropriate and efficient means of providing the graduated level of protections required by different investor categories.**

Pending full implementation of the above recommendations on the marketing and sales of hedge funds, there are a number of practical steps that European authorities and Member States can take to provide retail investors with access to hedge fund investing. In particular, the Group recognises the potential suitability of funds of hedge funds as retail products.

2: The majority of the Group recommends against reopening negotiations on the key provisions of the UCITS Directive with a view to facilitating the authorisation of a broad range of funds of hedge funds as UCITS. A minority considered that the time was right to broaden investment rules and other provisions of the UCITS directive to allow funds of hedge funds to be authorised as UCITS compliant funds.

3: The Group recognises the potential value in allowing retail investor access to hedge fund based investing by authorising UCITS to invest in derivatives on hedge fund indices. However, the majority of the Group recognises the validity of concerns regarding the reliability and functioning of hedge fund indices. The Group, with exception of one member, recommends that UCITS investment in derivatives based on such indices be deferred until concerns regarding the structure and performance of hedge fund indices are resolved.

4: Whilst concerned about the limitations associated with product regulation, the Group recommends that the European institutions and national authorities take all non-legislative steps needed to give effect to the mutual recognition of (nationally regulated) retail-oriented hedge fund products. These should be mutually recognised as suitable for sale to the investing retail public across the European market and for distribution under MiFID conditions. This should not be considered as a substitute for other reforms suggested with regards to improving the distribution regime for non-retail oriented funds.

A second subset of recommendations relates to regulatory provisions which unjustifiably limit the legitimate exercise of institutional investor appetite for hedge fund investments. A combination of arbitrary quantitative restrictions and potentially punitive capital penalties are imposed in certain Member States on insurance companies, pension funds and banks investing in hedge funds. This is contrary to a large body of research that supports hedge funds as an asset class for such investors and in spite of years of successful hedge fund investing in Europe. It is also inconsistent with the treatment of other investments such as equities which can have similar risk profiles for investors.

5: Regulators and industry bodies should remove absolute or arbitrary quantitative restrictions on hedge fund based investing which are imposed on some institutional investors. The Group advocates removal of any arbitrary and/or regulatory prohibition or restriction. The "prudent man" principle which informs the Directive on the activities and supervision of institutions for occupational retirement provision (IORP) should be more broadly applied.

6: The Group recommends that effective steps be taken to ensure a measured and appropriate implementation of the Capital Requirements Directive – one which does not result in exaggerated and prohibitive restrictions on bank investment in hedge funds. The European Commission and Committee of European Banking Supervisors should, at an early stage of the implementation of the Basle II framework, compare and reconcile the trading book rules in each Member State as well as how they are construed and applied by the competent supervisory authorities. Guidance is particularly needed in respect of the level of transparency that regulators should require when allowing banks a more favourable "look-through approach".

In addition, the Group recommends that the European Commission provides for appropriate provisioning requirements under its forthcoming proposals for Solvency II. The forthcoming draft Directive should not impose excessively onerous reserve requirements which would represent an unjustified deterrent to investment in hedge funds by life-insurers.

7: The Group urges the European Union and national authorities to enter into negotiations with the US Securities & Exchange Commission and other relevant parties with a view to securing exemption from the US registration requirements for European hedge fund managers who are already registered with a Member State authority and are doing business with US qualified investors. If new regulations are put in place due to the US Court of Appeals decision, the Group urges the European Union Commission to make appropriate comments and to enter into negotiations so that the final regulations that are put in place do not have adverse consequences for the European Hedge Fund industry and to specifically ensure that no dual registration is required for managers already regulated in Member States.

Creating a single market for hedge fund support services:

Due to reliance on regulatory concepts borrowed from the retail environment, nationally regulated hedge funds are currently not always able to choose service or liquidity providers from across Europe. Some providers have to comply with rules on liability of sub-custody networks or re-hypothecation which are often not appropriate to the risk/reward balance which exists in the hedge fund industry between funds and service providers. In addition to restricting the free movement of services between Member States, these rules can have the effect of reducing access to the best levels of service provision and efficiency in back and middle-office operations.

8: An absolute requirement for a local entity to perform custody functions for European hedge funds does not significantly increase the level of investor protection available above that required by such sophisticated hedge fund investors; in reality it restricts the ability of managers to generate returns which in turn impedes the ability of the European hedge fund industry to grow and

compete in the global market place. Such requirements also prevent the provision of cross border services by custodians in other Member States and stifle competition.

Member State regulators should not impose a requirement for the appointment of a domestic custodian upon European hedge funds. The Group recommends that the provider of custody services to a European hedge fund should be a regulated provider of custody services, either domestically or in another Member State, and that this should be coupled with a minimum assets requirement.

9: Custodians and prime brokers are established in highly regulated European jurisdictions and are subject to detailed rules governing the provision of custody services. The Group supports a requirement that custodians, whether appointed solely as custodians or as part of a prime brokerage mandate, should be obliged to act reasonably and take due care and skill in monitoring the sub-custodian.

In addition to the requirement that a custodian be regulated in a Member State, the Group would support the use of a minimum assets test by Member States. This would mean that a regulated firm that is appointed as a custodian to a European hedge fund would be subject to a minimum assets test and/or a requirement that the custodian or its ultimate parent hold a specified credit rating.

The Group recommends that Member State regulators and the Commission should seek to reduce regulatory discrepancies in this respect, especially in light of the intended harmonising effect of MiFID, with particular regard to the sections dealing with custody of client assets and the prohibitions against "gold-plating" the Level II provisions in domestic implementing legislation.

10: Re-hypothecation limits are a critical economic variable contributing to the cost and price of providing the prime brokerage service. Prime brokers are established in highly regulated Member States and are subject to detailed rules governing the provision of regulated services.

The Group recommends that neither Member States nor the Commission impose any regulatory restrictions upon re-hypothecation limits for European hedge funds and that such matters be regarded as commercial terms of business to be negotiated between the fund and the prime broker. Any right of re-hypothecation should, however, be transparent to investors through the medium of disclosure in the fund offering documents. The Group would support any requirement, either at Member State or Community level, that a right of re-hypothecation be coupled with an enforceable set-off clause in the brokerage documentation.

However, if a ceiling is considered necessary and supervisors insist on imposing some limit for investor protection reasons through further banking/prudential rules, then it is appropriate:

- **to measure that limit by reference to the level of indebtedness rather than by reference to the NAV of the fund. A prime broker can determine on any day how much the fund owes it but it cannot easily track the NAV because calculating this requires more information than is available to each prime broker, especially as most large funds now have more than one prime broker;**

- **to couple limitation on re-hypothecation with close-out netting provisions which would enable the setting off of the prime broker's redelivery obligation against the fund's liabilities to the prime broker; and**

– **to ensure that each Member State recognises that a prime broker regulated in another Member State is entitled to provide prime brokerage services (for example, custody, clearing, stock and cash lending, and research) to hedge funds regulated within its territory.**

11: As regards asset valuation, considering the global nature of hedge fund operation and the active participation of most Member State regulators in the IOSCO Standing Committee n° 5, the Group does not wish to pre-empt the IOSCO report and make specific recommendations at this time. Nevertheless, the Group is hopeful that IOSCO will not recommend the need for direct regulation or legislation in respect of hedge fund valuation and that it will advocate a system of best practice that relies upon industry led codes of conduct and permits different levels of independence in relation to the valuation function coupled with transparency for investors through full disclosure, thus allowing hedge fund investors to take the level of independence of the valuation function as well as the methodology into account as part of the due-diligence prior to investing.

A list of the Group's eleven full recommendations is set out in the annex to the main report.

1. Setting the record straight

Hedge funds can be best described by reference to common investment characteristics and practices. Hedge funds encompass a wide range of different investment objectives, strategies, styles, techniques and assets, offering a wide spectrum of risk/return profiles. The main characteristic of hedge funds is that they are more flexible in terms of investment options or strategies than traditional collective investments.

There is no comprehensive, uniform and universally accepted definition of a hedge fund or a hedge fund manager. European Member State rules regarding hedge funds do not employ formal, legal or specific definitions. This lack of legal precision has not stopped a lively and sustained policy discourse on hedge funds in recent years. The hedge fund industry appreciates the need for the heightened regulatory engagement that accompanies its rapid growth and deepening presence in global financial markets. This report represents an opportunity for some industry participants to communicate a business perspective on the key challenges standing in the way of successful growth of this business in Europe.

The lack of legal definition might lead to some misconceptions or misunderstandings in the policy making community. However, none of the recommendations that are made in this report requires any legal definition of hedge funds to be implemented.

1.1. The role of hedge funds in the financial system

The main driver of the success of hedge fund investing is the recognition of the usefulness of these strategies in terms of enhancing risk-adjusted portfolio performance.

Portfolio diversification: Inclusion of hedge funds in a balanced portfolio can reduce overall portfolio risk and volatility and increase returns - benefits derived from the low correlations between hedge funds and traditional assets. ECB[1] compared data from 1994 to 2004: all correlation coefficients between hedge fund family indices[2] and major stock market indices were small and even negative in some cases. The case for the inclusion of hedge funds in an investor's portfolio becomes even more compelling when historical risk-adjusted returns are taken into account. With the exception of certain directional strategies, other hedge fund strategies seem to outperform stock and bond markets on a risk-adjusted basis.

Positive and uncorrelated returns: Notwithstanding some reservations with respect to the accuracy of hedge fund indices, it has been argued[3] that hedge funds investment styles – many uncorrelated with each other – can produce attractive returns in both rising and falling equity and bond markets with lower overall market risk than long only investment funds. Hedge funds therefore offer longer term investment solutions, reducing the impact of traditional market cycles and the pressure to correctly time market purchases and sales.

Less volatile returns: Hedge funds target a wide range of volatility targets. However many hedge funds experience lower volatility than equity (long-only) UCITS[4] funds investing in growth stocks, technology stocks, or emerging markets. Hedge funds have also shown that they can provide capital preservation in sustained recent bear markets and many structured products also provide capital protection which removes capital risk.

The benefits of hedge funds are not confined to the level of individual portfolios. They have equal impact throughout the financial system.

Overall, by using a full range of financial instruments and by acting as the counterparty in many different markets, hedge funds play a key

[1] ECB Occasional papers, "*Hedge funds and their implications for financial stability*", August 2005
[2] CSFB/Tremont database
[3] Cf. the above mentioned ECB paper.
[4] Undertakings for collective investment in transferable securities (UCITS) under Council Directive of 20 December 1985 (85/611/EEC)

role in the reallocation of risks among market participants. Market developments in recent years have placed the risks of financing real economic activity in the hands of investors whose aversion to risk varies widely. Hedge fund varied strategies respond to different investors' risk profiles. Furthermore, hedge funds finance directly the companies by participating in capital-raising and thus, reduce the funding rates of innovative and/or risky projects.

Hedge funds improve the functioning of financial markets. They provide markets with liquidity and have a significant stabilizing influence by spreading risks across a broad range of investors. Indeed, hedge funds often take alternative market views (contrarian trading strategies), can leverage their positions and generally change their portfolio composition much more frequently than traditional funds. Hedge funds also tend to be active in newer developing markets, often creating sufficient liquidity to allow mainstream managers to follow (e.g. credit derivative markets, over-the-counter markets and syndicated bank loans). Hedge funds increase market efficiency through the arbitrage of price differences between similar securities across markets or (cf. IMF[5]) by providing price discovery (e.g. on credit derivative markets).

Through their ability to engage in short-selling and to take contrarian approaches, hedge funds may also act as a counterbalance to market herding. Concerns have been expressed that hedge funds can magnify "herding" and, so, contribute to asset bubbles in some markets. However, herding behaviour has not been proven to be inherent to hedge funds.

Hedge funds importantly contribute to (and actively benefit from) financial innovation. The impact of hedge funds on traditional funds has been compared[6] to that of cell phones on land lines and low budget airlines on flag carriers. Hedge funds are catalysts for change in the traditional fund universe and have prompted a major rethink of the ground-rules for asset management. Some mainstream investment managers have adopted long short or derivatives-based strategies. Others have chosen to provide absolute returns via other routes. Consequently, the borderline between hedge funds and mainstream investment funds is starting to blur.

An example relating to the back-office functions illustrates the innovation which is driven by hedge funds. Whilst automation and outsourcing of back-office functions are seen as a route to lowering costs and speeding up execution, hedge funds generally require skilled back-office operations, staff and systems, reflecting the greater complexities associated with many of the trading strategies employed and underlying investments held. These complexities result in a higher barrier to entry and require greater investment costs, both in terms of technology and skilled personnel. In this context, the hedge fund industry delegates certain back-office operations to a growing industry of service providers: administrators, prime brokers, custodians and others. The expertise offered by these experienced professional service providers often results in a higher degree of efficiency and professionalism within the operational functions.

1.2. *Demystification – challenging the myths*

In 2005, 39,989 press articles[7] mentioned "hedge funds", 43% above the previous 2004 record and more than 100 articles a day. Nevertheless, there are so many misconceptions and so much erroneous reporting about hedge funds that the Group believes that the record deserves to be set straight.

1.2.1. Hedge funds are not prone to fraud or market abuse

Recent research in the US[8] indicates it is not possible to conclude that hedge fund managers engage in fraudulent activities disproportionately or more frequently than managers of regulated funds. The Group would

[5] Global Financial Stability Review; April 2006.

[6] "Hedge funds: a catalyst reshaping global investment" KPMG-Create

[7] "100 times a day: Hedge funds and the media"; Waleck et Associates, March 2006

[8] Greupner, Erik J.: Hedge funds are headed down-market: a call for increased regulation? San Diego (2003)

further argue that the lack of instances of hedge fund fraud in Europe is attributable (at least in part) to the regulation of the hedge fund managers and the common European practice of using independent fund administrators. In addition, most reported frauds involve the use of hedge fund vehicles as a method of extracting money from their victims. As such, these instances relate more to the activities of the individuals concerned and are not intrinsic to hedge funds.

Hedge funds operating in European markets are subject to the Market Abuse Directive as are all other users of those markets. Additionally, the hedge fund industry, as well as other market participants, is working with regulators to establish where the boundaries lie so that the industry continues to act well within the law.

1.2.2. Hedge funds are no longer the preserve of super-rich and risk oriented investors

In the 1990s most hedge fund investments came from high net worth individuals. Although they increased their allocation to hedge funds, their share of the total declined to 44% in 2005 from 62%[9] in 1996 due to the rise in institutional capital. Indeed, recent years have been characterised by increased investment from institutional investors, which accounted for 26% of the assets invested in single hedge funds in 2005. Fund of funds also represented 30% of the share, with $395 billion under management at the end of 2005. Consequently, professional investors amounted to 56% of all investors at the end of 2005. In terms of inflows, research[10] projects that pension funds and other institutions will account for 52% of inflows into hedge funds in 2006 and 2007 and 53% in 2008. This compares with a 28% share of inflows in 2004.

1.2.3. Hedge funds are not a significant threat to financial stability

There is little evidence to suggest that hedge funds threaten financial stability. Some concerns have been expressed, for instance about the growing impact of hedge funds on the revenues of investment banks (revenue dependence). However, the difficulties triggered by the failure of the world's largest hedge fund (LTCM) in 1998 have prompted the tightening up of controls as investment banks have significantly improved the way in which they manage their exposures to hedge funds (greater selectivity, more collateralisation etc). Several public and private initiatives[11] have been launched to improve the risk management practices of the counterparties to hedge funds, and these have led to sounder practices. They specifically address areas such as banks' policies and procedures when dealing with institutions employing leverage, information gathering and credit analysis, exposure measures and the monitoring of such exposures, credit limits, and the link between credit enhancement tools (e.g. financial collateral or additional termination events) and the specific characteristics of such high-leverage institutions.

1.3. A challenge to established corporate governance models?

Concerns have been expressed that hedge funds are increasingly investing in companies and pushing for changes in the management or the strategy of those companies by imposing short-term views. In reality, the size of the hedge fund business, as well as the positive role it plays in company financing and financial markets, makes hedge funds more visible. They have become more active investors in corporate equity and active shareholders of the companies in which they invest. Many would argue that they are in fact the modern proponents of the shareholder-based model of corporate governance.

There is some pressure for institutional investors at least to be subject to greater transparency and to be obliged to disclose their voting policies (possible legislation is being discussed in a few Member States). However, there is no justification in principle for distinguishing between different types of institutional investors. Finally, hedge fund activities are monitored by regulators which are entitled to ensure that these participants respect relevant

[9] Source: Hennessee Group LLC and IFSL
[10] McKinsey Asset Management

[11] See the Counterparty Risk Management Policy Group II "*Toward greater financial stability, a private sector perspective*"; 27th July 2005 (so-called Corrigan II report)

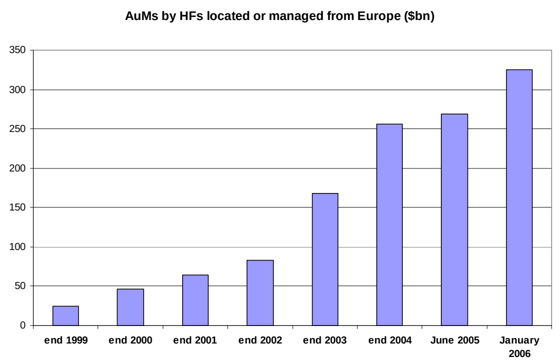
existing regulations, such as vetting the proper use of securities' lending possibilities, respecting rules on insider information and the rights of minority shareholders.

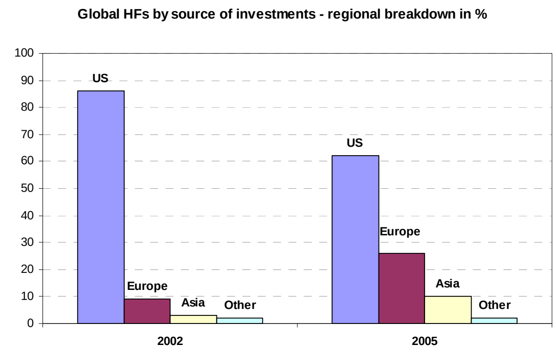
2. The European hedge fund market

2.1. The Success of the European industry

Assets under management of the global hedge fund industry totalled $1.2 trillion[12] at the first quarter of 2006 – an increase of 13% on the previous year. The number of hedge funds increased 6% in 2005 to reach around 9,000. At the end of 2004, assets managed by hedge funds represented 2.17% of the global assets managed by insurance, pension or investment funds (against 0.70% at the end of 1998).

The European market has been at the forefront of this growth[13]. Hedge funds corresponding to the working definition and located in or managed from the European Union numbered around 1,250 in January 2006. They have assets of more than US$ 325 billion. Interestingly, the European market share is growing as shown in the following charts[14]:





The average size of a European Union hedge fund is $258 million with variation around this average: in the United Kingdom, $325 million, in France $182 million, etc. It seems to be increasing.

The optimal location and form of each entity within the hedge fund business is frequently determined according to factors such as access to skilled professionals and potential investors, tax efficiency, proximity to major markets and having an appropriate regulatory regime. The European Union hedge fund business is consequently organised as follows:

Location of hedge fund managers: Most, if not all, hedge fund managers located within the territory of European Union Member States are subject to a supervision and authorisation regime. London is the second centre of management after New York at a global level. London is Europe's leading centre for the management of hedge funds. In January 2006, 78.5%[15] ($256 billion) of European hedge fund investments were managed out of the United Kingdom (or nearly two thirds of the number of European hedge funds). It is estimated that around 20% of global hedge fund assets are managed by United Kingdom hedge fund management groups which are fully regulated by the FSA.

Domicile of European Union hedge funds: Most hedge funds or products are companies, partnerships or trusts (or similar vehicles) domiciled in offshore jurisdictions which do not impose taxation on the vehicle, thus making the investment less disadvantageous from a tax

[12] This figure is estimated from various industry databases, as notably Hedge Fund Research, Inc at the first quarter of 2006. It might include bias or double-counting.

[13] In the following, the term "European Union hedge funds" refers to hedge funds incorporated or organised in the European Union and/or with managers incorporated or domiciled in the European Union. This includes hedge funds that are managed outside the European Union but are domiciled within the European Union and vice versa.

[14] Source: IFSL estimates based on EuroHedge and Hennessee

[15] Source IFSL Research and data provided by Eurohedge/Hedge Fund Intelligence

perspective for the end-investor. Offshore hedge funds are usually structured as corporations although may sometimes be structured as limited partnerships or unit trusts. At the end of 2004, 55% of the total number of global hedge funds - managing 64% of total hedge fund assets - were registered offshore versus 34% in the US; and 9% in the European Union. The most popular offshore location is the Cayman Islands (60% of European hedge fund assets) followed by the British Virgin Islands (15%) and Bermuda (15%).

Location of service providers: London is Europe's leading centre for prime brokerage and accounts for more than 90% of Europe's prime brokerage activity, as the largest investment banks are either headquartered or have a major office there. As regards hedge fund administration, Ireland and Luxembourg clearly dominate as administration centres in the European Union. Ireland-domiciled[16] administrators service over 3,000 hedge funds, representing more than US$474 billion of assets as at 30 June 2005. This covers about 50% of assets under management by European Union-hedge funds as described above. In Luxembourg[17], 59 fund administrators serviced €102 billion of hedge funds assets, at the end of 2005. However, new centres of fund administration are developing. All the offshore hedge fund jurisdictions allow those funds that prefer to maintain their records in a jurisdiction separate from their domicile to do so. Consequently, a significant number of hedge funds domiciled outside the European Union are administered in the European Union principally because of the access to skilled administrators and the relative ease of communication between manager and administrator. For instance, 62% of hedge funds administered from Ireland are funds registered in the Cayman Islands.

2.2. *Moving towards institutionalisation*

In Europe, 51% of institutional investors have already gained exposure to hedge funds, representing (on average) 7% of their assets. Pension funds in particular show an increasing level of interest in hedge funds. With funds of hedge funds as intermediaries, they have become more important as sources of capital in recent years, particularly for the larger and more established hedge funds. According to research[18], in 2005 12% of United Kingdom pension funds allocated on average 6.9% of their portfolios to hedge funds. In Continental Europe and Ireland, allocations are generally higher, with 13% of pension funds on average investing in this segment. Some market observers believe that in a couple of years pension funds could account for as much as half of all hedge fund inflows. A survey[19] of European pension funds shows that some pension funds rebalanced their asset allocation towards a higher proportion of equities and, above all, alternative assets such as property, commodities and hedge funds over the year 2005.

Funds of hedge funds saw net new money grow by 40% a year between 2002 and 2004, representing half of all flows into the industry. This was mainly due to first-time investors, particularly pension funds and private broker clients, looking to diversify their risks in a broad portfolio of hedge funds using disparate strategies. However, pension funds are increasingly showing interest in investing in single manager hedge funds.

Institutionalisation is having a positive influence on hedge fund processes. Today's hedge funds are increasingly monitored by professional managers at pension funds, endowments, foundations and even central banks. Institutions are typically more demanding than individual investors in requiring better investment processes and clearer reporting. For instance, they often require enhanced reporting on a frequent basis. The management of hedge fund businesses is becoming increasingly professional. The managers are monitored by the authorities of the Member State where they are located (78% in London). Institutionalisation is also enhancing the quality of hedge fund

[16] Dublin Fund Industry Association, Newsletter April 2006, Alternative Investment Funds.
[17] Association of the Luxembourg Fund Industry, statistical release, 7 March 2006

[18] JP Morgan Fleming Asset Management,2005 and Mercer Investment Consulting "*European institutional market place overview 2006*", May 2006
[19] Source: bfinance.co.uk

administration. It is driving a form of institutionalisation among administrators themselves. Institutional investors want a specialised quality administrator with experienced and appropriately qualified staff, independent pricing and valuation procedures, and the technology to support this enhanced role.

2.3. *The tax environment for European hedge funds*

The traditional hedge fund industry started in the US. Two distinct structures evolved to meet the tax needs of US investors. Limited partnerships are designed to minimise the tax liabilities of US taxable investors whilst offshore open-ended investment companies meet the needs of offshore investors and US tax exempt investors. The lack of a similarly competitive and coherent tax regime in the EU is a major factor in preventing the development of an EU wide hedge fund industry.

Whilst some Member States have tried to encourage alternative onshore structures, usually by imposing punitive taxation measures against investment in offshore funds, such measures, have met with limited success because there is insufficient demand from any one country to merit hedge fund managers setting up a plethora of onshore funds tailored to each tax regime. Instead, the hedge fund industries in those Member States are typically characterised by structures designed to circumvent the punitive tax regimes. Member States should recognise that offshore hedge funds are meeting pent up demand from investors and that investors will find a tax efficient way to invest in these vehicles regardless of local tax regimes.

The Investment Manager exemption (IME): One of the reasons for the great success of the hedge fund industry in the United Kingdom has been the clarity provided by the investment manager exemption. This essentially provides that the existence of a United Kingdom based fund manager will not bring a fund onshore for tax purposes provided that overall policy and control of the fund rests outside of the United Kingdom. The success of this approach is evidenced by the fact that other jurisdictions with aspirations to grow their hedge fund industries, such as Hong Kong and Singapore, have recently adopted similar legislation. The US similarly abandoned the so called "10 commandments" a number of years ago in order to clarify the position of onshore managers of offshore funds.

Where a fund has a UK investment manager, there is the potential for the fund to be treated as 'permanently established' in the UK and for the fund's profits to be subject to UK tax. This will only be the case if the fund is carrying on 'trading activities' rather than operating as an investment company and would, but for the IME, generally be relevant for hedge funds. The IME exempts UK managers of non-UK resident funds from UK tax on profits.

A number of conditions need to be satisfied for the IME to apply and include, most importantly, that the manager must be operating independently and the trading income must derive from 'investment transactions' (which covers financial instruments in common usage, including most cash settled derivatives).

The IME is, however, very narrowly drafted covering only those transactions in which a fund manager is involved. As the definition of investment transaction goes back to the early 1980's it has little or no relevance in today's markets. To seek to remedy this, there are some current discussions as to whether the exemption could be broadened to include some of the newer strategies that hedge funds have developed. The Group suggests that it is not in the interests of the industry or regulators to drive hedge fund managers offshore by introducing the risk that an onshore manager will bring the fund onshore for tax purposes. The Group believes that other Member States could benefit from adopting the IME.

2.4. *The regulatory environment for European hedge funds*

2.4.1. No specific legislation at European Union-level

Hedge funds are generally not structured in a way that allows them to be authorised as UCITS.

In particular, hedge funds do not adopt investment policies that comply with the strict investment limits imposed on authorised funds (UCITS). Rather than structuring highly restrictive UCITS authorised funds for the retail market, hedge funds have traditionally been targeted at high net worth investors and institutions who can invest in less restrictive fund structures. As a result, hedge funds have been promoted under a legislative patchwork, which varies across Member States, in some cases allowing for the private placement of products to non-retail investors, and in other cases prohibiting all such promotion.

Although there is no direct European legislation on the funds themselves, the various service providers within the hedge fund industry are subject, to varying degrees, to numerous European Directives including the Market Abuse Directive, Capital Adequacy Directive, Money Laundering Directive and, in the future, the Capital Requirement Directive, the Prospectus Directive and the Markets in Financial Instruments Directive (MiFID).

European Union banks and credit institutions (which are among the first tier of European investors in hedge funds) are (highly) regulated by European Union legislation (capital adequacy, collateral, due diligence requirements, risk control policies, etc.). The principal regulatory line of defence for banks lending to hedge fund counterparties is the revised Capital Requirement Directive. This will take effect at the end of 2006. While there is no special treatment for hedge fund exposures in the form of lending or of equity stakes, the new Capital Requirement Directive will introduce some relevant refinements (e.g. new rules on securities lending, which will affect prime brokerage business). It will also make it clear that equity stakes in hedge funds should not be held in the bank's trading book (where they get a more favourable capital treatment) unless they meet certain transparency and liquidity requirements. These considerations are further discussed below.

2.4.2. Different national approaches to a global business

Several Member States have recently introduced national regulatory regimes[20] to provide an environment for the onshore management, constitution and distribution of hedge funds and funds of hedge funds. These regimes typically involve registration and oversight of hedge fund managers, as well as structural separation of the hedge fund manager and the custodian. The main rationale appears to be aimed at bringing onshore what was previously offshore and allowing restricted access of retail investors to these products. In some Member States, the freedom for asset managers to act within trading strategy limits is counter-balanced by a ban on offering to the public. In other Member States, "hedge funds" can be offered to the public, but at the price of a significant restriction of the asset manager's freedom to determine the content, policies and practices of the investment. In addition to the requirement for the hedge fund manager to be registered and to hold minimum capital, these regimes may often involve regulation at some or all of the following levels:

– **Investment restrictions/product regulation**: Some Member States have established authorisation regimes for funds. These may regulate some aspects of product performance or investment policy (such as diversification limits, use of leverage, valuation and other portfolio constraints). These regimes considerably vary from one Member State to the next. The Group is strongly of the view that product regulation is likely to create arbitrary and misplaced or out of date restrictions which negatively impact on portfolio construction and performance and are unlikely to be in the best interests of investors.

– **Fund constitution/administration**: The approach of most Member States to regulation of hedge funds borrows widely from the structural principles that have been laid down in UCITS law for traditional investment funds – namely independent controls on valuation of the funds and its positions, existence of a depositary to

[20] See table 1 in annex

perform certain risk controls etc. All Member States, following the example of the UCITS Directive, require the existence of a custodian for the fund's assets in order to ensure that investors' assets are kept separate and recognise that the fund manager can utilise the services offered by the prime broker. However, the custodian's duty of care, and therefore liability, for the actions of its sub-custody network varies across Member States.

- **Distribution to retail investors**: Member States take significantly different approaches to the public offering of hedge funds and related products in their jurisdictions. Some Member States impose a minimum subscription amount or qualitative tests relating to the target audience to whom hedge funds can be sold to limit the marketing of hedge funds to the retail public.

- **Distribution to qualified investors**: Many Member States have set up a national regime for private placement that may be used by the distributors of hedge funds, provided certain conditions are met. The basic premise of 'private placement' is that regulation should not encroach on the ability of private parties to freely enter into a contractual relationship, where the contracting parties are capable of understanding the nature of the bargain, including any attendant risks. However, private placement regimes vary in terms of who is eligible to invest and the products that can be promoted. Eligibility is sometimes conditional on the "institutional" nature of the investor, sometimes by reference to a (limited) number of subscribers, a minimum subscription or holding amount, or in terms of who is active in soliciting business. Finally, some regimes may limit the possibility of private placement to specific kinds of security (e.g. closed-end fund shares). The result is a legal minefield which hedge fund managers or promoters must attempt to negotiate before being able to distribute across Europe. The consequences of operating within the scope of the private placement regime also differ. In some cases, the consequences may be limited to a waiver from the obligation to publish a prospectus or other mandatory disclosures. Compliance with certain promotion rules (such as marketing techniques) and mandatory product registration with the local regulatory authority may also be required.

Thus, although they present some common features, these regimes considerably vary from one Member State to another[21]. This regulatory fragmentation creates a barrier to the cross-border distribution of hedge funds and is a major impediment to the development of a European wide industry from a distribution perspective. It results in undue restrictions and acute uncertainty as regards the conditions under which distribution can be conducted. One of the major implications is that those investors, who can contract with a hedge fund manager under the law of another jurisdiction, invest offshore. In addition to preventing the creation of a scalable onshore business, it also results in inefficiencies in constructing, managing and administering portfolios, and in providing support services to the industry, thus resulting in higher costs and greater complexity. If Member States wish to provide a regulatory environment which is conducive to the successful development of a European presence in this industry, they should take enlightened steps to remove these inefficiencies.

3. Cross-border marketing and distribution of hedge funds

There is a growing demand from investors for access to the range of investment opportunities offered by the hedge fund industry. Thus, the demand for hedge fund investments in a properly diversified portfolio (which is supported by research) is no longer restricted to professional or institutional investors.

Traditionally, hedge fund based investing has been off-limits for retail investors. Regulators have been reluctant to allow small, inexperienced investors to dabble in products

[21] "Hedge Funds Regulation in Europe"; A comparative survey; November 2005; EFAMA

that they perceived as using highly complex trading strategies. The hedge fund industry did not consider the commercial stakes sufficiently compelling to restructure its products or challenge this perception and assume all the regulatory overheads that servicing the mass market would entail. Many hedge fund boutiques are still of this opinion and wish to exclusively focus on their traditional investor base, albeit that this investor base may include funds of hedge funds whose end investors are changing.

However, the situation is changing as a result of strong demand from investors for a wider range of options. The hedge fund industry is well equipped to respond to this demand. Institutionalisation of the hedge fund industry is driving increased transparency, more sophisticated valuation techniques, and operational risk management (cf. section 2.2.). This makes it easier for many hedge fund managers to serve a broader investor base which in turn is finding that traditional investments are becoming more complex in any event (reportedly 70% of retail fund managers are making extensive use of derivatives-based leverage to deliver capital protection and absolute returns).

The hedge fund industry wishes to service this changing investor base as efficiently as possible. It would like to do so from scalable established platforms and centres of excellence. This will allow economies of scale and the best management expertise to develop. The industry cannot afford the cost or diseconomies of scale in building local management presence or fund administration in each target market. The hedge fund community is used to managing business models which span different regulatory jurisdictions. They are used to serving a sophisticated clientele dispersed across several continents.

However, as the industry develops, restrictions on cross-border marketing (where available at all) are proving increasingly costly in terms of foregone opportunities (for both managers and investors), legal uncertainty and heavy compliance costs. These costs come without any tangible benefit in terms of investor protection or risk-adjusted portfolio performance. They are increasingly hard to justify when the success of hedge funds is a matter of record. They weigh heavily on hedge fund business and its investors. For instance, well-intentioned national measures merely succeed in pushing investors to obtain hedge fund access through other means, such as acquiring hedge fund exposure through structured products, shares in closed-end funds or investing offshore. As a result, cross-border marketing restrictions are adding to the cost of acquiring hedge funds in terms of the further level of complexity and/or a distortion in the competition between different forms of products. They do not achieve their intended goal.

The Group believes that it is time to move on from the current sub-optimal situation. Recent regulatory developments within the European Union provide an opportunity for a fresh look at arrangements governing the Europe-wide distribution of hedge funds. These developments could overcome unnecessary obstacles to cross-border placement of hedge funds with qualified investors who are capable of self-directed investment. The Group also calls for a rational and dispassionate debate on the appropriate conditions under which retail access to hedge fund-based investments could be contemplated. The Group would like to propose an approach which will provide those investors who want to access hedge fund investing with the ability to do that under secure conditions. This approach is based on two levels of protection.

3.1. *Level one: eligibility restrictions to limit exposure of less qualified retail investors*

In order to avoid the inappropriate exposure of less qualified retail investors to hedge fund investing, the Group considers that it would be opportune to retain some constraints or "eligibility control" on the possibility for individual investors to invest in hedge funds. In particular, a majority of Group members considered it appropriate to require a minimum consideration of 50'000€ per offer from each investor.

A substantial minority of Group members considered that this monetary threshold would not be sufficient to disqualify retail investors for whom hedge fund based investing may not be suitable. Some members belonging to this minority considered that the recommended threshold should be raised. Other members of this minority felt that alternatives to a monetary amount should be used – for example, a process-based system. Still others argued that additional conditions – such as a requirement that the manager be regulated in a Member State or an OECD country – would be appropriate.

3.2. Level two: regulation and supervision of distributor or arranger

For all investors who meet this eligibility condition, a second level of protection would be provided by the regulation and supervision of the intermediary or institution which sells or places the investment. To the extent that the intermediary is appropriately regulated and supervised and properly acquits all duties of care to the end-investor, there should be no need for further regulation at the level of the investment product (including hedge funds), the issuer/fund manager (the Group notes that 95% of European hedge fund assets are managed by managers domiciled in Europe) or other actors in the chain.

A shift to a greater focus on supervision of intermediaries is already implied by the Prospectus Directive in respect of complex securities. However, the Group notes the inconsistency that exists in respect of the "Qualified Investor" regime created under the Prospectus Directive when looked at in the context of cross border sales of hedge funds. It is hard to defend a regime that allows the sale of individual equity and debt securities to certain classes of person without any regulatory intervention as to the "product" whatsoever and yet does not allow similar flexibility for hedge funds which may well have lower volatility, lower leverage and a more diversified portfolio of risk than a single company stock. This position supports the minimum investment suggestion put forward by the majority of the Group. The spirit of the Qualified Investor regime, possibly extended in specific circumstances to retail investors, can be achieved through the MiFID regime.

Thus, the Group considers that where the institution or participant which concludes a contract with the end-investor is authorised or regulated in accordance with MiFID provisions, there is no need for further regulatory oversight of the product or the manager. This approach would be neutral in respect of the fund domicile, legal structure, its investment policy or strategy and its administration and prime brokerage arrangements. Hedge funds and related products, irrespective of domicile of the fund, the manager, custodian or fund administrator, could be sold under MiFID regulation cross border without triggering additional local requirements in terms of disclosures, product registration or investor protection.

The MiFID Directive, the implementation of which is not yet finalised and which is scheduled to be transposed into the national law of Member States in November 2007, establishes a set of effective disciplines for controlling behaviour of distributors. This would pave the way for a consistent approach across Europe regarding the distribution and sales of hedge funds and related products to different categories of investors.

It would clearly fall to the distributor to take account of the specific situation and sophistication of different investors notably by implementing the graduated levels of conduct of business protection that are foreseen in the MiFID Directive. This Directive – the detailed implementation of which is still being worked out – provides extensive harmonisation and prescription in terms of the types of protection that should be offered to different categories of investors. In particular, it would imply that:

- Financial institutions (when they do not explicitly request to be treated as professional investors) and other eligible counterparties would not be owed any conduct of business duties;
- Professional investors (as defined in the MiFID annex) would receive a light-touch version of the conduct of business protections; and

- Retail investors would be owed the full set of conduct of business obligations. This would encompass risk warnings, relevant disclosures, and suitability and appropriateness tests.

<u>Recommendation # 1</u>: Member States should recognise the broadening investor appetite for hedge funds and related products by developing a regulatory approach that is compatible with these needs and the organisation of the hedge fund business.

The Group recommends that European authorities and supervisors allow the provision of investment services in respect of the full range of hedge funds and related products by investment firms authorised in accordance with MiFID – without imposing additional restrictions or formalities at the level of the fund, its manager or other participants in the value chain.

In particular, the Group recommends that regulators do not seek to control sales and distribution through product regulation or registration. The Group is of the view that regulators should focus, instead, on two levels of protection:

- **First, the Group recommends that conditions be introduced to prevent access to hedge funds by investors for whom such investments are not suitable. A majority of Group members considered a minimum threshold of 50'000€ would satisfy this condition. A substantial minority considered that a higher threshold and/or other safeguards should apply;**

- **Second, the Group recommends the enforcing of clear conduct of business requirements on the intermediaries and institutions who conclude sales contracts with end-investors. This is an appropriate and efficient means of providing the graduated level of protections required by different investor categories.**

3.3. *Cross-border retailing of suitable hedge fund products:*

Pending the implementation of MiFID rules along the above lines, and a shift to intermediary focused regulation, there are additional steps that European authorities can take to respond to the changing profile of hedge fund investors. These pragmatic steps build on existing national initiatives which are already being taken to facilitate broader investor access to hedge fund-based investing.

Box: Current channels for bringing hedge based investing to the European retail investor

A gradual broadening of the hedge fund investor base to retail investors is already underway. This trend should not be overstated. The breakdown of assets under management by source of capital does not show significant direct inflows from retail customers. However, retail clients are gaining increased access to hedge fund-based investments through the following routes:

<u>Listed closed-end hedge funds:</u> some hedge funds have a European stock exchange listing. Most listed funds (when they have appointed a market maker) present investors with the benefit of improved liquidity whilst offering the product provider with access to a new audience of investors and a stable pool of capital to manage. Historically, closed-end funds may have traded at a significant discount to their net asset values and some products have not been considered as a success. Since the adoption of approaches to narrow the discount to net asset value, this is no longer the case in London where most funds launched in the last 12 months trade at a premium, not a discount. The demand for hedge funds within this type of structure is increasing. Listed shares can be sold across the European Union upon launch on the basis of a simple prospectus and traded on an exchange or OTC. Listed funds have to comply with transparency and reporting requirements. Their transactions and intermediation providers are fully regulated by the MiFID.

<u>Structured notes based on underlying hedge funds</u> are successful in terms of market size. It is estimated that of the $1.2 trillion[22] of assets under management, approximately $100-150 billion is

[22] Source: Hedge Fund Research, Inc, at the first quarter of 2006

invested via structured products. These products are estimated to account for 20-25% of net capital inflows to hedge funds at global level. They are still seen as the 'vehicle of choice' among many participants within the hedge fund industry for a variety of reasons, including economic flexibility (such as capital protection combined with attractive risk adjusted returns) and tax benefits particularly in those markets where there are punitive tax regimes to discourage direct investment in hedge funds. It is worth noting that, to a certain extent in the current regime, structured notes may also be sold on a cross-border basis under the Prospectus Directive. With regard to investor protection, the investor base of structured products includes 56%[23] retail (mass market or mass affluent) investors in Europe. The distribution of such products takes place through regulated channels (retail banks, financial advisors, fund distributors) most of which will be fully covered under MiFID.

Although some members believe that a level playing field between all kinds of product structure is desirable, the Group considers that the current channels for marketing the securities of listed closed-end funds and structured notes do not require additional regulation. In both cases, necessary checks and balances are in place at the level of issue and issuer, and at the level of the distribution networks where the relevant private banking or banking networks owe fiduciary obligations to their clients. Recent moves to facilitate a more open, disclosure based approach, specifically by the United Kingdom Listing Authority is encouraged.

The Group believes that regulators should now move to recognise this reality by allowing direct retail access to suitable forms of hedge fund investment. The Group looked at two alternative routes.

First, many traditional fund managers are developing their product range to include absolute return and "alpha" strategies. UCITS III has been a catalyst for these developments by extensively broadening the scope of eligible assets for UCITS to include the use of on-exchange and OTC financial derivatives. It has also allowed extensive index-tracking strategies and the use of derivatives for return-enhancing purposes. As a result of these changes, a new generation of **UCITS III funds potentially give retail investors access to some of the absolute return performance characteristics of hedge funds**, albeit it remains to be seen how such funds will perform. However, it is premature to talk about the convergence of retail investment fund strategies and hedge funds. It is the Group's assessment that it will remain difficult to shoe-horn any more than a handful of hedge fund strategies or funds of hedge funds into the UCITS framework. This will remain the case – even after confirmation that UCITS will be able to invest in shares of listed closed-end funds as long as they meet strict conditions. UCITS investment in open-ended hedge funds will also remain difficult – largely closing the door on bringing funds of hedge funds to market under a UCITS authorisation. Moreover, the structural conditions on valuation, redeemability and portfolio liquidity (which may often be at the price of lower returns) have proven to be too restrictive for all but a few hedge funds to date.

The Group gave some consideration to possible adjustments to the relevant provisions of the UCITS Directive to allow a broader population of funds of hedge funds to be authorised and marketed across Europe as UCITS. Some Group members also cautioned against the dangers of over-stretching the UCITS label. The Group concluded that this would amount to a major undertaking. Several of the core features of the UCITS Directive would need to be extensively reshaped. Given the scale of the challenge, and the uncertainty about the magnitude of the benefits compared to other proposed routes for opening up retail market access, the Group decided to advise against such a course of action.

A small minority argued that the UCITS Directive should be modified to accommodate funds of hedge funds by adding hedge funds to the list of eligible assets. The eligibility of hedge funds could depend on compliance with a certain number of minimum requirements and a certain degree of diversification.

The second much-touted route to providing retail investors with access to hedge fund-based investing is allowing UCITS to invest in

[23] Source: Datamonitor

derivatives on hedge fund indices. This could represent a promising route for the future. However, the Group believes that such products are less obviously suited to retail investors than funds of hedge funds. They do not present the same level of diversification. There are also open questions regarding the reliability and robustness of hedge fund indices and the valuation of derivatives based upon them. The Group encourages the industry to work constructively with CESR and the European Commission to examine these concerns and to identify the appropriate conditions under which UCITS could be permitted to invest in derivatives on hedge fund indices. One Group member argued that derivatives on hedge fund indices should be recognised by European legislation on the grounds that hedge fund indices can contribute to a better benchmarking of this business.

Additionally, the Group notes that, whilst some Member States have created certain locally supervised products, they do not extend similar marketing possibilities to comparable products authorised under other Member States' rules.

In particular, several Member States have authorised the sale of funds of hedge funds to retail investors on the grounds that they provide diversified exposure to this asset class. This has been the case, for instance, in France, Germany, Ireland, Luxembourg and Spain. Whilst there are concerns regarding the level of product regulation that some of these regimes introduced, the Group welcomes this approach and believes funds of hedge funds (or well diversified hedge funds) could provide significant benefits to a wide range of investors for whom the case may be that investment in offshore or traditional hedge funds is not appropriate.

Mutual recognition of nationally authorised hedge funds would be a logical extension of single market principles to products which are explicitly designed and authorised with the retail investor in mind and would dovetail with the full implementation of MiFID. It would recognise, moreover, that retail investors already enjoy indirect access to hedge fund investing through structured products and securities issued by listed closed-end hedge funds. Certain Member States already implement such a practice[24] whereby they allow the marketing to their retail investing public. Group members believe that the hedge fund industry could be allowed to use these national concepts to build a retail investor base across the single market. Building on the mutual recognition principle would allow the cross-border marketing of such products without the need for the painstaking and unproductive harmonisation of product features.

Whilst concerns were noted about the risk of product regulation, which is evident in some national Member State hedge fund regimes to date, the Group was in favour of progressing towards **<u>mutual recognition of hedge fund products which have been authorised for sale to retail investors under different national regimes</u>**. Provided that the distributor is regulated under MiFID and acquits all his duties of care, these products could then be sold to retail investors on a cross-border basis. Recognition should be extended to the organisation of the participants to the value chain as they are registered with Member State authorities. However, the Group is of the view that mutual recognition must not be viewed as a substitute for the other reforms proposed, for example, making the existing regimes for cross border sales to institutions and sophisticated investors (who are likely to require products that would not qualify for mutual recognition) less restrictive.

<u>Recommendation # 2</u>: The majority of the Group recommends against reopening negotiations on the key provisions of the UCITS Directive with a view to facilitating the authorisation of a broad range of funds of hedge funds as UCITS. A minority considered that the time was right to broaden investment rules and other provisions of the UCITS directive to allow funds of hedge funds to be authorised as UCITS compliant funds.

[24] Cf. Some Member States allow, for instance, Luxembourg Part II funds (non-harmonised funds including some hedge funds) to be marketed to their retail investing public.

Recommendation # 3: The Group recognises the potential value in allowing retail investor access to hedge fund based investing by authorising UCITS to invest in derivatives on hedge fund indices. However, the majority of the Group recognises the validity of concerns regarding the reliability and functioning of hedge fund indices. The Group, with exception of one member, recommends that UCITS investment in derivatives based on such indices be deferred until concerns regarding the structure and performance of hedge fund indices are resolved.

Recommendation # 4: Whilst concerned about the limitations associated with product regulation, the Group recommends that the European institutions and national authorities take all non-legislative steps needed to give effect to the mutual recognition of (nationally regulated) retail-oriented hedge fund products. These should be mutually recognised as suitable for sale to the investing retail public across the European market and for distribution under MiFID conditions. This should not be considered as a substitute for other reforms suggested with regards to improving the distribution regime for non-retail oriented funds.

3.4. Regulatory restrictions on the buy-side

Under-funded pension funds are seeking new asset classes or investment styles offering access to equity-like premium without all the associated risks. Because of their focus on absolute performance and risk control and because they offer non-linear return profiles, hedge funds are particularly useful in an asset/liability management context. Hedge funds and other alternative investments can therefore form an effective component in a suitably diversified portfolio. Experiences from some Member States (e.g. Netherlands) point to the benefits of sensibly managed investment in hedge funds. Despite this, there are many rules in place at a national level which restrict the possibility for some financial institutions of obtaining prudent exposure to hedge funds. Life insurance companies in particular, are often prohibited from investing in hedge funds, except for their own account, on the basis that they have underwritten premia with retail policy-holders.

The table 2 in the annex illustrates the varying treatment of investor restrictions on hedge fund investments across Member States. There is no discernible pattern to these restrictions – either across countries or sectors. This suggests that these restrictions are relatively arbitrary and not grounded in any coherent regulatory or prudential considerations. Furthermore, restrictions on direct exposure to hedge funds may often be circumvented by using legal loopholes, where the case may be. Thus, even if the aim of preventing institutions investing in hedge funds was justified these restrictions rarely achieve this goal. They simply add legal uncertainty and costs.

Recommendation # 5: Regulators and industry bodies should remove absolute or arbitrary quantitative restrictions on hedge fund based investing which are imposed on some institutional investors. The Group advocates removal of any arbitrary and/or regulatory prohibition or restriction. The "prudent man" principle which informs the Directive on the activities and supervision of institutions for occupational retirement provision (IORP[25]) should be more broadly applied.

Capital provisioning rules for banks and insurance companies:

The appetite for banks to invest in hedge funds (the Group is not concerned with bank lending to hedge funds) is heavily influenced by the capital reserves that banks are required to hold against such positions under the Basel II rules and the (soon to enter into force) Capital Requirements Directive. This affects their appetite and raises their capital costs. Two considerations determine how much capital banks must hold against hedge fund investments.

The first issue is whether banks can assign investments in hedge funds to the trading book.

[25] Directive 2003/41/EC of the European Parliament and the Council on the activities and supervision of institutions for occupational retirement provision (IORPs)

This would entitle them to less onerous capital provisioning than if they were allocated to the banking book: the latter involves holding reserves of 300-1200% of exposure which is prohibitively expensive. In principle, Basel II rules and the Capital Requirement Directive allow for hedge fund exposures to be held on trading book if the units are fully transferable and eligible for daily marking to market and if they are held for trading purposes. However, the Basel Committee and most regulators in the European Union have elected not to use the discretion available to them.

Second, when allocating hedge fund shares to the banking book, banks must comply with minimum capital requirements for credit risks. In doing so, they generally have the choice between two methodologies: the standardised approach supported by external credit assessments and an alternative approach (the so-called IRB approach), which allows banks to use their internal ratings for measuring credit risk. However, for some asset classes, like equity exposure, the bank's discretion is limited. Regulators frequently impose a very restrictive approach – on the grounds that a hedge fund does not provide full transparency of its investment strategy or the assets it invests in. Consequently, banks may be required to treat the hedge fund shares they hold as equity exposure attracting the highest capital requirement. Finally, regulators require banks to take a worst case scenario approach, assuming that the hedge fund invests in the asset classes involving the highest capital requirements (e.g. in junior CDO tranches). The consequence could be an effective risk weight of 1,250%. Clearly, under such conditions, banks will drastically scale back investment in hedge funds – this outcome does not represent a true reflection of the risk of hedge fund investing for credit institutions. It leads to underinvestment in the asset class by banks and denies hedge funds the possibility of raising funds from the major actors in the financial system.

<u>Recommendation # 6</u>: The Group recommends that effective steps be taken to ensure a measured and appropriate implementation of the Capital Requirements Directive – one which does not result in exaggerated and prohibitive restrictions on bank investment in hedge funds. The European Commission and Committee of European Banking Supervisors should, at an early stage of the implementation of the Basle II framework, compare and reconcile the trading book rules in each Member State as well as how they are construed and applied by the competent supervisory authorities. Guidance is particularly needed in respect of the level of transparency that regulators should require when allowing banks a more favourable "look-through approach".

In addition, the Group recommends that the European Commission provides for appropriate provisioning requirements under its forthcoming proposals for Solvency II. The forthcoming draft Directive should not impose excessively onerous reserve requirements which would represent an unjustified deterrent to investment in hedge funds by life-insurers.

3.5. Legal restrictions on offering European hedge funds outside of Europe

The Group draws attention to obstacles to marketing European hedge funds outside Europe, notably in the United States. Since February 2006, European hedge fund managers which market their funds in the US must be registered with the SEC, even where sales are restricted to qualified investors. Consequently, European hedge fund managers must undergo authorisation procedures on both sides of the Atlantic before being able to serve US clients. This creates significant costs and forces managers to structure their operations to comply with two different regulatory systems. Conversely, US hedge fund managers are often not faced with local registration requirements at manager level when their products are placed with European qualified investors, although the situation differs with regards to the authorisation of the product itself. The European Commission, CESR and the relevant national authorities are urged to secure balanced treatment for European hedge fund managers doing business in the US. Many Group members were of the view that, if the European Union moves to a more open market place as implied by the shift to an intermediary-based approach, then every effort should be made to secure reciprocal treatment of European hedge fund managers in the US.

Although at the time of writing it is too early to understand fully the implications of the very recent decision of the US Court of Appeals[26], this may lead to the termination of the registration requirement. The Chairman of the SEC has announced in a press release that he has *"instructed the SEC's professional staff to promptly evaluate the Court's decision, and to provide to the* [SEC] *Commission a set of alternatives…"*. The Group believes that, after such evaluation, the European Commission should make appropriate comments and enter into negotiations so that the final regulations that are put in place do not have adverse consequences for the European hedge fund industry.

Recommendation # 7: The Group urges the European Union and national authorities to enter into negotiations with the US Securities & Exchange Commission and other relevant parties with a view to securing exemption from the US registration requirements for European hedge fund managers who are already registered with a Member State authority and are doing business with US qualified investors. If new regulations are put in place due to the US Court of Appeals decision, the Group urges the European Union Commission to make appropriate comments and to enter into negotiations so that the final regulations that are put in place do not have adverse consequences for the European Hedge Fund industry and to specifically ensure that no dual registration is required for managers already regulated in Member States.

[26] United States Court of Appeals for the District of Columbia Circuit, No. 04-1434 on Petition for Review of an Order of the Securities and Exchange Commission, Decided June 23, 2006

4. Servicing the European hedge fund industry

The success of the hedge fund industry has come about in large part because the commercial interests of all parties are broadly aligned. Successful hedge fund activity requires strong operational support services to process and settle trades globally and for the majority of hedge fund strategies, the availability of leverage at commercially viable rates together with access to a reliable source of securities available for borrowing.

However, those Member State policy makers who have sought to create a market for domestic hedge funds have recognised the need for flexibility of investment approach but have often failed to appreciate that a similar flexible approach must be taken with respect to the choice of service providers. Regulatory fragmentation as regards rules governing authorisation, access and operation of service providers performing administration, custody, clearing and settlement functions for hedge funds leads to inefficiencies and creates barriers hindering the efficient development of the hedge fund market in the European Union. Furthermore, some hedge fund service providers established in the European Union and who are active on a global basis, and indeed are market leaders within the wider hedge fund industry, are restricted or limited in their ability to provide their services to hedge funds on a cross-border basis within the European Union. This regulatory fragmentation is an obstacle to the emergence of healthy competition amongst hedge fund service providers and is likely to prevent European hedge funds from competing at a global level where they are unable to appoint "best of breed" service providers across borders in other Member States.

A number of commentators and regulators have expressed concerns in relation to the valuation of complex assets traded by some hedge funds and the fact that a lack of transparency or independence in such a complex process may disadvantage investors. In an attempt to tackle any potential conflict of interest, some authorities advocate regulation of this function or suggest that it be performed by an independent third-party service provider. Whilst superficially attractive, a closer examination of the nature of the instruments to be valued and the expertise available in the market demonstrates that such a requirement, if applied too rigidly would be unlikely to reduce the opportunity for error or fraud, would not significantly increase investor protection, and may in fact operate as a barrier to the proper allocation of responsibility and the efficient development of the hedge fund market in the European Union. The Group is however in favour of the independent valuation of hedge fund assets and an appropriate disclosure to investors, should this not be the case.

4.1. Domestic custodian requirement

Outside of the European Union, the hedge fund industry has developed without any requirement for a domestic custodian to be appointed in addition to a prime broker. However, the overwhelming majority of Member States that have sought to establish a domestic hedge fund industry to date have created a requirement that a local custodian, established and regulated in the same jurisdiction as the hedge fund, be appointed. Some Member States have gone even further and required the domestic custodian to have absolute responsibility for the hedge fund's assets and the performance of the underlying network of sub-custodians.

National rules in this area seem to have been derived in the main from the existing UCITS regime notwithstanding the fact that such a regime has been designed around the concept of retail investor protection and traditional long only funds. Whilst no doubt a useful investor protection tool in the long only investment fund sector, such protections are not required in the hedge fund sector. Domestic custodian requirements are counter productive as they provide a false sense of security and hinder the manager's ability to generate returns.

4.1.1. Questioning the added-value of such a requirement

The requirement for a <u>domestic</u> custodian arises for reasons of perceived investor protection and these can be examined under two main headings: (a) protection from the failure of the custodian to perform its basic custody duties adequately, referred to as the "safekeeping role"; and (b) protection from the failure of the investment manager to manage the fund in accordance with its investment guidelines, referred to as the "oversight role".

The rationale in respect of the **safekeeping role** is that the authorising regulator will be better able to determine the suitability and stability of the custodian to perform its duties if it is regulated by the same authority and established in the local jurisdiction. As a practical matter, hedge funds need a service provider to perform custody functions because most hedge funds invest in markets on a global basis and will own securities issued in countries other than the one in which they are organised. As a result, the hedge funds will need a local custodian or depositary to hold those securities in each of the countries in which they have invested. Seeking out, employing and subsequently monitoring these custodians itself is impractical for a hedge fund management operation in terms of time, expertise and resources. Therefore hedge funds need a "global custodian" who will seek out, employ and monitor the sub-custodians. In practice, this role is played by the prime broker who delegates the custody functions to the local sub-custodians in each jurisdiction.

Prime brokers are key participants in the hedge fund value chain. In addition to the vital clearing and settlement services that they perform, without access to the cash and securities lending liquidity that prime brokers provide, hedge funds could not function effectively. In order for hedge funds to be able to provide their services, prime brokers are required, from a practical and a legal certainty perspective to have custody of the hedge fund's assets:

– In order to settle transactions on behalf of the fund, a prime broker needs to be able to transfer assets or cash as soon as trade instructions are received from an investment manager on behalf of a fund. The practicalities of inserting a further domestic custodian into the flow of instructions between the investment manager and prime broker significantly increases the operational and cost burden, makes effective and timely trade settlement more difficult and increases the likelihood that the settlement will fail.

– Providing a hedge fund with margin finance and access to securities lending or short sales coverage services involves the prime broker taking on a degree of credit risk to the hedge fund. Naturally, prime brokers require that they act as custodian to the hedge fund's positions in order to take an effective first priority security interest over the fund's account to cover such credit exposure.

Where Member States have established domestic custodian requirements and local funds have been launched, the practical effect of the two commercial drivers set out above has meant that in every case, custody of fund assets has been delegated in its entirety by the local custodian to the prime broker who acts as "global sub-custodian". The local custodian does not have day to day control of the assets. The only difference between these arrangements and those more commonly seen in the global hedge fund market is that there are an additional set of fees to be paid to the custodian (which reduces investor returns) and the prime broker has to provide additional reporting to the custodian.

The majority of, if not all, prime brokers performing custody functions to hedge funds established in the European Union are themselves established in highly regulated Member State jurisdictions and as a result, are subject to close regulatory scrutiny and detailed rules governing the provision of custody services. The level of regulation applicable to prime brokers in their own Member States is a persuasive counter-argument to the requirement for a local custodian, whether it takes control of the fund property or otherwise, particularly when one considers that local custodians do not in practice have either custody or control of the hedge fund assets. It is industry practice for the identity of the prime broker and the level of responsibility that it takes for its sub-custodial network to be disclosed in hedge fund offering documents, both in the traditional offshore space and the nascent onshore industry in Europe. Accordingly, this information is often available to investors prior to making an investment.

The traditional rationale for the **oversight role** is that a custodian will necessarily see all movements in and out of the hedge fund account and will be able to determine from this whether or not the movements instructed by the investment manager are consistent with the fund's investment guidelines and/or the manager's authority. The fitness and propriety of the investment manager is a matter for the fund's directors/promoters and authorising regulator at the time that the fund is launched, together with the regulator in the jurisdiction from which the manager operates if different from that of the fund. In this regard, it is worth noting that the majority of hedge fund managers operating in the European Union are located in Member State jurisdictions where they are therefore subject to detailed local regulation of their activities. For example, 78% of such managers are located in the United Kingdom and are regulated by the Financial Services Authority.

In addition, it is also worth noting that traditional providers of custodial or deposit bank functions may not be in a position to understand and monitor complex hedge fund strategies and where exposure is taken via OTC derivative transactions, such activity may not be directly visible to the custodian in any event.

Given the level of regulation under which most established investment managers operate within the European Union, the benefits of additional oversight by a local custodian or prime broker are questionable when weighed against the additional costs. In addition, sophisticated investors of the type which invest in hedge funds often place greater reliance on due diligence that they undertake themselves rather than on a third-party service provider such as a custodian.

<u>Recommendation # 8</u>: **An absolute requirement for a local entity to perform custody functions for European hedge funds does not significantly increase the level of investor**

protection available above that required by such sophisticated hedge fund investors; in reality it restricts the ability of managers to generate returns which in turn impedes the ability of the European hedge fund industry to grow and compete in the global market place. Such requirements also prevent the provision of cross border services by custodians in other Member States and stifle competition.

Member State regulators should not impose a requirement for the appointment of a domestic custodian upon European hedge funds. The Group recommends that the provider of custody services to a European hedge fund should be a regulated provider of custody services, either domestically or in another Member State together with a minimum assets requirement.

4.1.2. The question of responsibility

The level of responsibility that a custodian has for the assets of the fund and the performance of sub-custodians differs across the globe with three main models evidenced:

– By far the most common model accounting for over 90% of hedge funds worldwide is that which exists in the main Anglo Saxon centres, the US and the United Kingdom. In this model there is no requirement for a domestic custodian and the prime broker is appointed directly. The prime broker as custodian is required to act reasonably and/or with due care and skill in selecting and monitoring the performance of any sub-custodian that it uses to hold customer assets but provided that it has acted reasonably or with due care and skill, it is not liable for the fraud or failure of any sub-custodian so selected. This level of responsibility is consistent with the standards set out for depositing client financial instruments in Article 17 of the Level II Directive of MiFID.

– In a few Member States, the domestic custodian currently bears absolute legal responsibility to redeliver assets to the fund under local law in the event of fraud or failure of a sub-custodian regardless of whether that sub-custodian was selected with due care and skill. The domestic custodian may delegate asset safekeeping to the prime broker. However, bearing in mind that it no longer benefits from the full safekeeping fee income and has no control over the prime broker's sub-custody network but bears all the risk of that network, it is likely to want the prime broker to contractually accept and indemnify it for any sub-custodian liability. This additional level of responsibility is one that to date the majority of prime brokers have been unwilling to fully accept. The domestic custodian's position is understandable but so is that of the prime broker who cannot manage these risks and whose custody business model does not require or allow for the effective guarantee of sub-custodians. The effect of this stand-off has been that in these jurisdictions, prime brokers have been severely restricted in their ability to fully offer their traditional services cross-border. It should also be noted that such a requirement is inconsistent with the Level II MIFID legislation mentioned above.

– The third model is a compromise or "intermediate" model; a domestic custodian is required but the rules relating to the provision of custody services require the custodian to take only reasonable care and skill in the selection and monitoring of sub-custodians. They are not liable for their fraud or failure. Consequently, domestic custodians do not need to impose higher standards upon prime brokers when delegating custody duties. Although this model allows the domestic custodian / prime broker relationship to function, it is still an unnecessary encumbrance upon the efficiency of the hedge fund industry but it does allow it to function. Some observers argue that, of the Member States who have established domestic hedge fund industries, the two which are undergoing the quickest development are the two which have adopted this compromise or intermediate model.

The Group believes that the national provisions setting out custodian responsibility explain in large part the success of the hedge fund industry in some jurisdictions as against the limited take-off of it in other countries. Given that sophisticated investors are more likely to undertake on-going due diligence, giving them a fuller picture of the operational limits/risks of the hedge fund, its manager and its counterparties, the Group is of the view that the custodian, whether domestic or otherwise, should not bear full liability for asset restitution and sub-custodian performance. Instead, it should only be under an obligation to use reasonable or due care and skill in selecting and monitoring any sub-custodians in accordance with the standards set out in Article 17 of the Level II Directive of MIFID.

The Group is concerned that those national regulators who have sought to create rules under which hedge funds can be authorised have imposed additional layers of control over the activities of the prime brokers. This additional control may act against the interests of investors and significantly reduces the range of markets and instruments such hedge funds can invest in. Hedge funds set up within such constraints will inevitably under-perform as against more traditional funds without a significant reduction in risk. In a market that is defined by absolute returns this can prove fatal. Hedge funds should be encouraged to use prime brokers which are regulated in Member States (or equivalent regulatory regimes) by allowing any such regulated prime broker to act for a hedge fund subject to its own appetite for risk and normal commercial standards of care in appointing sub-custodians. Whether a custodian is located in the same Member State or another Member State, the liability standard should be that of a duty to use reasonable or due care and skill with regard to the selection of and ongoing monitoring of the sub-custodial network.

Some members of the Group noted that in one Member State a type of alternative investment fund exists that, whilst not a true hedge fund, has wider investment capabilities than a UCITS III fund and is aimed at investors that although more expert than traditional retail UCITS investors, are nevertheless not as sophisticated as the traditional offshore hedge fund investor. It could be argued that these intermediate investors need greater protection and that one way to deliver this is to insist upon a domestic custodian who perhaps has liability for its sub-custodial network. However, such a requirement would, for the reasons given above act as a restriction on the ability of non-domestic service providers to offer their services to such funds, thereby restricting the ability of the fund to generate returns for investors with no real gain in investor protection. If there is a need for greater investor protection then the most appropriate focus is to ensure appropriate behaviour of the manager.

Recommendation # 9: Custodians and prime brokers are established in highly regulated European jurisdictions and are subject to detailed rules governing the provision of custody services. The Group supports a requirement that custodians, whether appointed solely as custodians or as part of a prime brokerage mandate, should be obliged to act reasonably and take due care and skill in monitoring the sub-custodian.

In addition to the requirement that a custodian be regulated in a Member State, the Group would support the use of a minimum assets test by Member States. This would mean that a regulated firm that is appointed as a custodian to a European hedge fund would be subject to a minimum assets test and/or a requirement that the custodian or its ultimate parent hold a specified credit rating.

The Group recommends that Member State regulators and the Commission should seek to reduce regulatory discrepancies in this respect, especially in light of the intended harmonising effect of MiFID, with particular regard to the sections dealing with custody of client assets and the prohibitions against "gold-plating" the Level II provisions in domestic implementing legislation.

4.2. Re-hypothecation

Re-hypothecation is a term of art used to describe use by the prime broker of assets belonging to a hedge fund. The commercial driver behind re-hypothecation is the fact that prime brokers lend cash and securities to hedge funds and that capital to support these activities has itself to be raised. In simple economic terms, the use of hedge fund assets by prime brokers is a key factor in reducing borrowing costs, thereby increasing returns, for hedge funds. Any assets which a prime broker has used or re-hypothecated will cease as a legal matter to belong to the hedge fund and the hedge fund will acquire a right to the redelivery of equivalent assets from the prime broker. In the event of an insolvency of either party, the obligation to redeliver will be given a cash value and will form part of a set off calculation against the amount the fund owes the prime broker. To the extent that the prime broker has re-hypothecated assets in excess of the amount that the hedge fund owes then the hedge fund would be an unsecured creditor for that excess following the operation of set-off. Against that risk, the more assets a prime broker is able to use, the lower overall cost of funding that hedge funds have to pay.

In some jurisdictions concerns over prime broker insolvency have driven legislative restrictions on the amount of assets that can be re-hypothecated in excess of the fund's current indebtedness to the prime broker. Restrictions have been observed as low as 100% for 140% of indebtedness and in some jurisdictions, that limit is a percentage of the net asset value of the hedge fund and not its indebtedness to the particular prime broker. The effect of these restrictions is a net increase in financing and securities borrowing costs for funds in these jurisdictions compared with the costs for hedge funds established in jurisdictions which do not impose such a limit. These higher costs act to reduce the returns available to investors, restrict the appetite of the providers of leverage to become involved in a "zero sum game" and combine to militate against the jurisdiction as one of choice for fund promoters and service providers.

The rationale behind a limit on re-hypothecation is clearly a concern to protect the investor against the risk of default of the prime broker. However, the cost of achieving that goal must be balanced against the other needs and the sophistication of the investor. Prime brokers are international investment banks subject to prudential supervision under the Capital Requirements Directive.

The Group believes therefore that rather than imposing an artificial limit, direct tools exist to manage the risk of default of the prime broker, as addressed in the European Union banking prudential rules. As a consequence, there is no need to build in "double lock" protection. Ideally, the strict limits of re-hypothecation should be negotiated as part of the commercial terms of business between the fund and the prime broker.

<u>Recommendation # 10</u>: Re-hypothecation limits are a critical economic variable contributing to the cost and price of providing the prime brokerage service. Prime brokers are established in highly regulated Member States and are subject to detailed rules governing the provision of regulated services.

The Group recommends that neither Member States nor the Commission impose any regulatory restrictions upon re-hypothecation limits for European hedge funds and that such matters be regarded as commercial terms of business to be negotiated between the fund and the prime broker. Any right of re-hypothecation should, however, be transparent to investors through the medium of disclosure in the fund offering documents. The Group would support any requirement, either at Member State or Community level, that a right of re-hypothecation be coupled with an enforceable set-off clause in the brokerage documentation.

However, if a ceiling is considered necessary and supervisors insist on imposing some limit for investor protection reasons through further banking/prudential rules, then it is appropriate:

- **to measure that limit by reference to the level of indebtedness rather than by reference to the NAV of the fund. A prime broker can determine on any day how much the fund owes it but it cannot easily track the NAV because calculating this requires more information than is available to each prime broker, especially**

as most large funds now have more than one prime broker;

- **to couple limitation on re-hypothecation with close-out netting provisions which would enable the setting off of the prime broker's redelivery obligation against the fund's liabilities to the prime broker; and**
- **to ensure that each Member State recognises that a prime broker regulated in another Member State is entitled to provide prime brokerage services (for example, custody, clearing, stock and cash lending, and research) to hedge funds regulated within its territory.**

4.3. The challenge of hedge fund asset valuation

The calculation of hedge fund net asset value or "NAV" is a vital task because the price at which investors purchase and redeem the shares or units of the fund is based on the NAV, as is the level of management fees paid to the manager. NAV calculations are complex but not difficult when undertaken by a reliable third-party fund administrator. The widely acknowledged challenge facing the hedge fund industry is the issue of the asset valuations that form the inputs to the NAV calculation. Many assets traded by hedge funds do not present a valuation problem as they are traded on a recognised exchange or another liquid market and quotes and prices are readily available from recognised reputable pricing sources such as Bloomberg or Reuters. Valuation becomes more of an issue with illiquid or unquoted assets and highly structured derivative products, created by and sold by certain financial institutions. For these illiquid or unquoted securities, a valuation is often difficult to determine and may be based upon an estimate (through well tested models) prepared either by the manager or by a third-party provider. In the case of highly structured products the ability to derive a realistic value resides only with the highly skilled traders and structurers at the investment banks that sell the products or the hedge fund managers that buy them, not with third party administrators or pricing service providers.

If the investment manager is calculating the value of the fund, a metric by which its level of fee revenue is measured, there is potential conflict of interest between the hedge fund manager and the investors. Despite this, the traders/portfolio managers of an appropriately regulated hedge fund manager are in fact often better placed than third-party valuation agencies or administrators to value complex positions. There are third-parties (a small number of administrators and specialist valuation agents) who are prepared to offer a full valuation service. However, in reality the level of compensation within the administration/ valuation sector of the hedge fund industry is not at a level that allows these entities to retain and remunerate highly skilled structurers and traders with the relevant experience and expertise to value such complex positions accurately.

One method, among others, that may offer advantages in addressing this potential conflict of interest is the "managed account" structure. In such structures, the traditional role of the manager is divided between the "trading advisor", which manages the day to day positions of the fund, and the "manager", which follows the risks and makes sure investment guidelines are respected, but also supervises and controls the valuation made by the administrators. In some of these structures, the valuation for the fund can be undertaken independently of the trading advisor.

It is true that third-party vendors are increasingly trying to offer competent valuations in respect of complex assets; however, in the short to medium term, there remain doubts as to the reliability of the services provided by these participants. One concern with complex positions is that there are no standardised pricing references. However, large banks and broker dealers, including prime brokers, are increasingly finding themselves in the position of intermediating third-party OTC's transactions between client hedge funds and executing brokers, and as a result their valuations on such positions may be used. These valuations are not independent as the brokers are a principal party to the intermediated transactions; however, such valuations are often required to be made in good faith and can prove a useful reference source for any manager or other party preparing a fund valuation.

The Group wishes to make it clear that the issue of valuations and the headline topics described briefly above are of relevance to the global hedge fund industry and not simply the industry in Europe.

As regards hedge fund assets' valuation, AIMA, on a global basis, has issued 20 recommendations[27] to investment managers and administrators. Furthermore, IOSCO[28] has decided that a set of valuation principles may generally prove of value to collective investment schemes' regulation and global markets. IOSCO's standing committee n° 5 (SC5) received a mandate on "hedge funds valuation and administration". The approach proposed by SC5 is based on an interaction process with the industry, notably with an AIMA working group, on the key issues relating to the valuation of hedge funds. The final output in the shape of draft principles is expected for public consultation at the 2007 annual meeting of IOSCO.

Finally, the Group point out that investors undertake ongoing due diligence allowing them to check the methodology of asset valuation. The hedge fund servicing industry is increasingly specialised and professional. The prevailing view amongst industry experts is that the valuation of hedge fund assets is not an issue that can be addressed by legislation or the imposition of a requirement for an independent third party. Valuation is most appropriately managed by adherence to industry-led codes of conduct and best practice coupled with transparency of the valuation process for investors. The Group is of the same view and would urge that Member States refrain from implementing regulatory requirements in respect of valuation which might serve to restrict the growth of the hedge fund industry in Europe.

Recommendation # 11: As regards asset valuation, considering the global nature of hedge fund operation and the active participation of most Member State regulators in the IOSCO Standing Committee n° 5, the Group does not wish to pre-empt the IOSCO report and make specific recommendations at this time. Nevertheless, the Group is hopeful that IOSCO will not recommend the need for direct regulation or legislation in respect of hedge fund valuation and that it will advocate a system of best practice that relies upon industry led codes of conduct and permits different levels of independence in relation to the valuation function coupled with transparency for investors through full disclosure, thus allowing hedge fund investors to take the level of independence of the valuation function as well as the methodology into account as part of the due-diligence prior to investing.

Conclusion

The European hedge fund industry has the potential to become a strong pillar of the European financial system. The Group welcomes this opportunity to put forward suggestions as to how policy makers can help to build on this success. It hopes that it has helped to clear up some of the misconceptions about hedge funds.

The hedge fund industry has grown to meet demand from investors for a wider range of products. This demand continues to grow because the industry continues to meet those requirements. The development of sophisticated financial products has created a virtuous circle whereby more and more investors are beginning to see the advantages of absolute return investment strategies.

Policy makers should reconsider whether, in seeking to protect investors, they are inadvertently denying those same investors access to the products and fund managers that are most capable of meeting their investment needs.

[27] AIMA "Asset Pricing and Fund Valuation in the Hedge Fund Industry", April 2005

[28] The International Organisation of Securities Commissions is composed of financial market regulators at global level which cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets.

ANNEX

TABLE 1: OVERVIEW OF NATIONAL REGULATORY REGIMES

Country	Regulated products	Retail	Minimum
France	*OPCVM à règles d'investissement allégées (ARIA)* and *OPCVM ARIA à effet de levier (ARIAEL)*	Yes	€ 125.000[29]
	OPCVM contractuels		€ 250.000
	OPCVM de fonds alternatifs (funds of hedge funds)	Yes	€ 10.000[30]
Germany	*Sondervermögen mit zusätzlichen Risiken (Hedgefonds)*	No, but private placement possible	None
	Fund of hedge funds	Yes	
Ireland	Professional Investor Fund	No	€ 125.000
	Qualifying Investor Fund		€ 250.000
	Fund of hedge funds	Yes	None
Italy	*Fondi speculativi* Speculative fund	No	€ 500.000
	Fund of hedge funds		
Luxembourg	Undertakings for collective investment pursuing alternative investment strategies	Yes	None
Portugal	*Fundo Especial de Investimento*	Yes	€ 15.000
Spain	IIC de Inversión libre	No	€ 50.000
	IIC de IIC de Inversión Libre (Fund of hedge funds)	Yes	None
United Kingdom	Qualified Investor Scheme	No	None
	Fund of hedge funds	Yes	

[29] There is no minimum investment for qualified investors or non France-based investors.
[30] No minimum investment threshold provided that there is a capital guarantee or for non-French investors.

TABLE 2: INVESTOR RESTRICTIONS ON HEDGE FUND INVESTMENTS

VARYING TREATMENT IN EUROPE MEMBER STATES

Member State	Insurance Companies	Pension Funds
France	➢ **Allowable subject to severe restrictions** ➢ Up to 10% of eligible assets in hedge fund, PE and non-regulated funds so called "*other assets ratio*" ➢ Foreign funds, if UCITS yes, if not fall under non-regulated funds, above	➢ **Not allowable** ➢ AGIRC and ARRCO 05 guidelines ➢ Forbid access to hedge funds or funds of hedge funds ➢ Sometimes access possible via structured products, under certain conditions
Germany	➢ **Allowable subject to restrictions** ➢ White funds only (and limited choice) ➢ Can buy certificate and package ➢ Limited to 5% of assets 1% in each fund ➢ Restriction on foreign funds which must be managed in EEA regulated company ➢ Must respect risk ratio	➢ **Allowable subject to restrictions** ➢ "*Pensionskasse*" (traditional occupational schemes) are subject to the same restrictions as insurance companies (see above) ➢ "*Pensionsfonds*" (more recent form of occupational schemes) are not subject to the same quantitative investment restrictions but are restricted by the requirement to invest in white funds/certificates with tax transparency
Italy	➢ **Not allowable** ➢ ISVAP refused to relax rules despite lobby from Italian industry ➢ Structured products – not acceptable Tax Italian funds favoured by lower 12.5% rate. Therefore investments typically via Italian SGRs	➢ **Allowable** ➢ YES: subject to quantitative restrictions typically 15% of pension fund assets. ➢ 5% maximum for non OECD products.
The Netherlands	➢ **Allowable - No restrictions** other than prudent, diversified investment using agreed risk management tools	➢ **Allowable - No restrictions** other than ALM to determine ALM surplus funds and no increase in overall risk
Spain	➢ **Not allowable** ➢ No for technical provisions but new rules could allow allocation to Spanish funds ➢ Foreign funds may also be possible if managed in OECD – up to 10% ➢ No restrictions on free capital	➢ **Not allowable** except if based in Basque country.
United Kingdom	➢ **Allowable subject to restrictions** ➢ Limited by capital resources requirement ➢ invested in "admissible assets" ➢ If CIS – they must invest in admissible assets ➢ If hedge funds not admissible assets not likely to be attractive	➢ **Allowable** ➢ Required to invest primarily in regulated markets ➢ May therefore prefer listed hedge funds ➢ Limited use of derivative contracts means very restricted use of managed accounts

List of the Group's 11 recommendations

Recommendation # 1: Member States should recognise the broadening investor appetite for hedge funds and related products by developing a regulatory approach that is compatible with these needs and the organisation of the hedge fund business.

The Group recommends that European authorities and supervisors allow the provision of investment services in respect of the full range of hedge funds and related products by investment firms authorised in accordance with MiFID – without imposing additional restrictions or formalities at the level of the fund, its manager or other participants in the value chain.

In particular, the Group recommends that regulators do not seek to control sales and distribution through product regulation or registration. The Group is of the view that regulators should focus, instead, on two levels of protection:

- First, the Group recommends that conditions be introduced to prevent access to hedge funds by investors for whom such investments are not suitable. A majority of Group members considered a minimum threshold of 50'000€ would satisfy this condition. A substantial minority considered that a higher threshold and/or other safeguards should apply;

- Second, the Group recommends the enforcing of clear conduct of business requirements on the intermediaries and institutions who conclude sales contracts with end-investors. This is an appropriate and efficient means of providing the graduated level of protections required by different investor categories.

Recommendation # 2: The majority of the Group recommends against reopening negotiations on the key provisions of the UCITS Directive with a view to facilitating the authorisation of a broad range of funds of hedge funds as UCITS. A minority considered that the time was right to broaden investment rules and other provisions of the UCITS directive to allow funds of hedge funds to be authorised as UCITS compliant funds.

Recommendation # 3: The Group recognises the potential value in allowing retail investor access to hedge fund based investing by authorising UCITS to invest in derivatives on hedge fund indices. However, the majority of the Group recognises the validity of concerns regarding the reliability and functioning of hedge fund indices. The Group, with exception of one member, recommends that UCITS investment in derivatives based on such indices be deferred until concerns regarding the structure and performance of hedge fund indices are resolved.

Recommendation # 4: Whilst concerned about the limitations associated with product regulation, the Group recommends that the European institutions and national authorities take all non-legislative steps needed to give effect to the mutual recognition of (nationally regulated) retail-oriented hedge fund products. These should be mutually recognised as suitable for sale to the investing retail public across the European market and for distribution under MiFID conditions. This should not be considered as a substitute for other reforms suggested with regards to improving the distribution regime for non-retail oriented funds.

Recommendation # 5: Regulators and industry bodies should remove absolute or arbitrary quantitative restrictions on hedge fund based investing which are imposed on some institutional investors. The Group advocates removal of any arbitrary and/or regulatory prohibition or restriction. The "prudent man" principle which informs the Directive on the activities and supervision of institutions for occupational retirement provision (IORP) should be more broadly applied.

Recommendation # 6: The Group recommends that effective steps be taken to ensure a measured and appropriate implementation of the Capital Requirements Directive – one which does not result in exaggerated and prohibitive restrictions on bank investment in hedge funds. The European Commission and Committee of European Banking Supervisors should, at an early stage of the implementation of the Basle II framework, compare and reconcile the trading book rules in each Member State as well as how they are construed and applied by the competent supervisory authorities. Guidance is particularly needed in respect of the level of transparency that regulators should require when allowing banks a more favourable "look-through approach".

In addition, the Group recommends that the European Commission provide for appropriate provisioning requirements under its forthcoming proposals for Solvency II. The forthcoming draft Directive should not impose excessively onerous reserve requirements which would represent an unjustified deterrent to investment in hedge funds by life-insurers.

Recommendation # 7: The Group urges the European Union and national authorities to enter into negotiations with the US Securities & Exchange Commission and other relevant parties with a view to securing exemption from the US registration requirements for European hedge fund managers who are already registered with a Member State authority and are doing business with US qualified investors. If new regulations are put in place due to the US Court of Appeals decision, the Group urges the European Union Commission to make appropriate comments and to enter into negotiations so that the final regulations that are put in place do not have adverse consequences for the European Hedge Fund industry and to specifically ensure that no dual registration is required for managers already regulated in Member States.

Recommendation # 8: An absolute requirement for a local entity to perform custody functions for European hedge funds does not significantly increase the level of investor protection available above that required by such sophisticated hedge fund investors; in reality it restricts the ability of managers to generate returns which in turn impedes the ability of the European hedge fund industry to grow and compete in the global market place. Such requirements also prevent the provision of cross border services by custodians in other Member States and stifle competition.

Member State regulators should not impose a requirement for the appointment of a domestic custodian upon European hedge funds. The Group recommends that the provider of custody services to a European hedge fund should be a regulated provider of custody services, either domestically or in another Member State together with a minimum assets requirement.

Recommendation # 9: Custodians and prime brokers are established in highly regulated European jurisdictions and are subject to detailed rules governing the provision of custody services. The Group supports a requirement that custodians, whether appointed solely as custodians or as part of a prime brokerage mandate, should be obliged to act reasonably and take due care and skill in monitoring the sub-custodian.

In addition to the requirement that a custodian be regulated in a Member State, the Group would support the use of a minimum assets test by Member States. This would mean that a regulated firm that is appointed as a custodian to a European hedge fund would be subject to a minimum assets test and/or a requirement that the custodian or its ultimate parent hold a specified credit rating.

The Group recommends that Member State regulators and the Commission should seek to reduce regulatory discrepancies in this respect, especially in light of the intended harmonising effect of MiFID, with particular regard to the sections dealing with custody of client assets and the prohibitions against "gold-plating" the Level II provisions in domestic implementing legislation.

Recommendation # 10: Re-hypothecation limits are a critical economic variable contributing to the cost and price of providing the prime brokerage service. Prime brokers are established in highly regulated Member States and are subject to detailed rules governing the provision of regulated services.

The Group recommends that neither Member States nor the Commission impose any regulatory restrictions upon re-hypothecation limits for European hedge funds and that such matters be regarded as commercial terms of business to be negotiated between the fund and the prime broker. Any right of re-hypothecation should, however, be transparent to investors through the medium of disclosure in the fund offering documents. The Group would support any requirement, either at Member State or Community level, that a right of re-hypothecation be coupled with an enforceable set-off clause in the brokerage documentation.

However, if a ceiling is considered necessary and supervisors insist on imposing some limit for investor protection reasons through further banking/prudential rules, then it is appropriate:

– to measure that limit by reference to the level of indebtedness rather than by reference to the NAV of the fund. A prime broker can determine on any day how much the fund owes it but it cannot easily track the NAV because calculating this requires more information than is available to each prime broker, especially as most large funds now have more than one prime broker;

– to couple limitation on re-hypothecation with close-out netting provisions which would enable the setting off of the prime broker's redelivery obligation against the fund's liabilities to the prime broker; and

– to ensure that each Member State recognises that a prime broker regulated in another Member State is entitled to provide prime brokerage services (for example, custody, clearing, stock and cash lending, and research) to hedge funds regulated within its territory.

Recommendation # 11: As regards asset valuation, considering the global nature of hedge fund operation and the active participation of most Member State regulators in the IOSCO Standing Committee n° 5, the Group does not wish to pre-empt the IOSCO report and make specific recommendations at this time. Nevertheless, the Group is hopeful that IOSCO will not recommend the need for direct regulation or legislation in respect of hedge fund valuation and that it will advocate a system of best practice that relies upon industry led codes of conduct and permits different levels of independence in relation to the valuation function coupled with transparency for investors through full disclosure, thus allowing hedge fund investors to take the level of independence of the valuation function as well as the methodology into account as part of the due-diligence prior to investing.

COMPOSITION OF THE EXPERT GROUP ON HEDGE FUNDS

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Mr	Jack	Tracy	UK	Morgan Stanley
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Ms	Florence	Lombard	INT	AIMA	Industry
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