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Hedge Funds: Heading for a regulatory hard landing?

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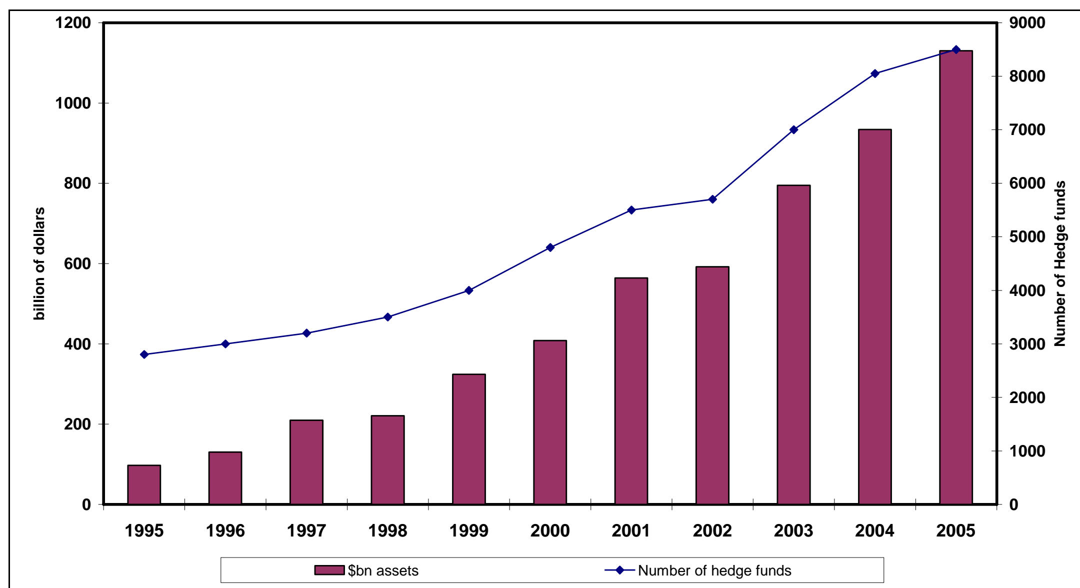
The hedge fund industry has been booming over the past decade. Assets under the management of hedge funds have increased ten-fold and the number of hedge funds has tripled (see Figure 1). Since hedge funds are 'leverage-prone' market players, they often take up positions that are larger than their actual assets under management. Such buoyancy and the increased 'retailisation' of the industry have awakened the interest of regulators. The US Securities and Exchange Commission (SEC), in particular, is striving to come up with appropriate regulatory procedures, despite the Goldstein ruling and the absence of any serious repercussions for the financial system from the recent bankruptcy of the Amaranth Hedge Fund, which reassured market participants that the current framework is adequate.

On this side of the Atlantic, the regulation of hedge funds at the European level is just emerging as a policy debate. According to its Green Paper on Financial Services Policy (2005-2010),[1] the European Commission announced that it does not have plans to push for regulatory initiatives in the area of hedge funds. Given the dynamism of the industry and its current growth in European financial markets, this stance reflects a fatigue[2] in the field of financial services regulation, but is also attributable to the fact that the European hedge fund industry remains at a different stage of maturity than its US counterpart.

Figure 1. The global hedge fund industry



Source: Hennessee Group LLC; IFSL estimates for 2005.

The raw facts

The phenomenal growth of the global hedge fund industry, which is heavily headquartered offshore (64% as of 2004) and is mostly managed in the US and the EU, is due among other things to its light regulation relative to other collective investment vehicles. However, the US plays a more prominent role and the EU is lagging behind; in 2004, 53% of the funds under management had a manager located in the US, whereas 27% of them were based

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[1] http://ec.europa.eu/internal_market/finances/docs/actionplan/index/green_en.pdf

[2] See Jean-Pierre Casey, "After the Financial Services Action Plan: A report of the post-1992 blues?", ECMI Regulatory Comment No. 1, April 2006.

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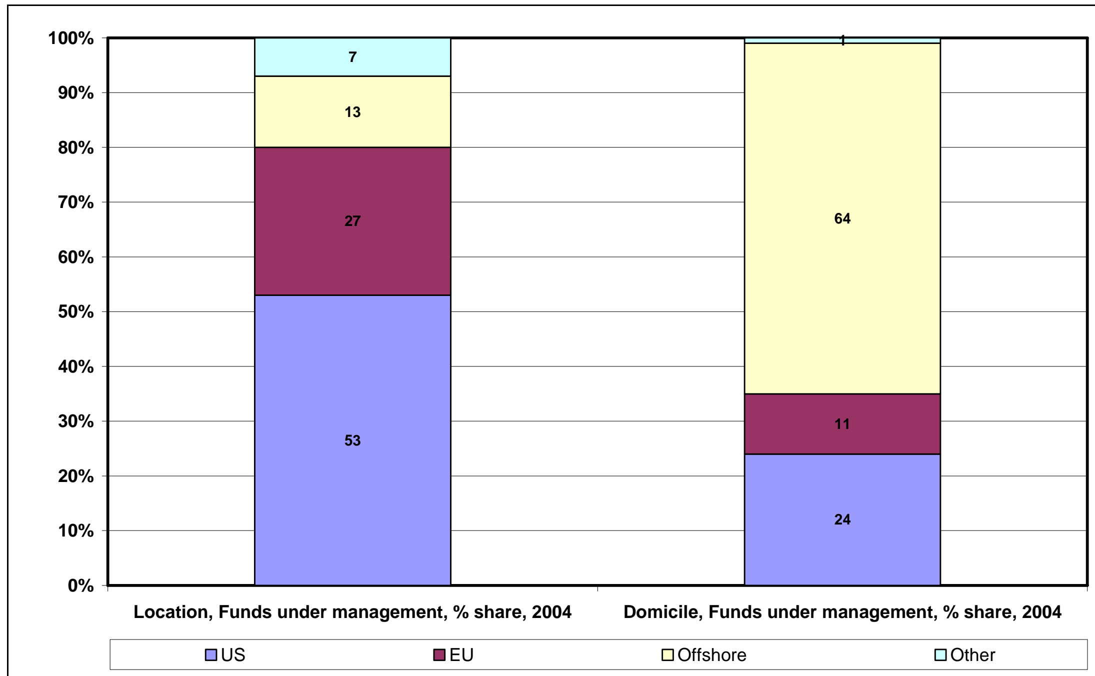
in the EU, and 11% of the funds under management had their corporate headquarters in the EU, compared to 24% in the US. Since hedge funds first emerged in Europe at the beginning of the 1990s, London has arisen as the centre of the European industry, managing two-thirds of the $325 billion of funds under management, although most of the funds remain held in offshore centres, as Figure 2 illustrates.

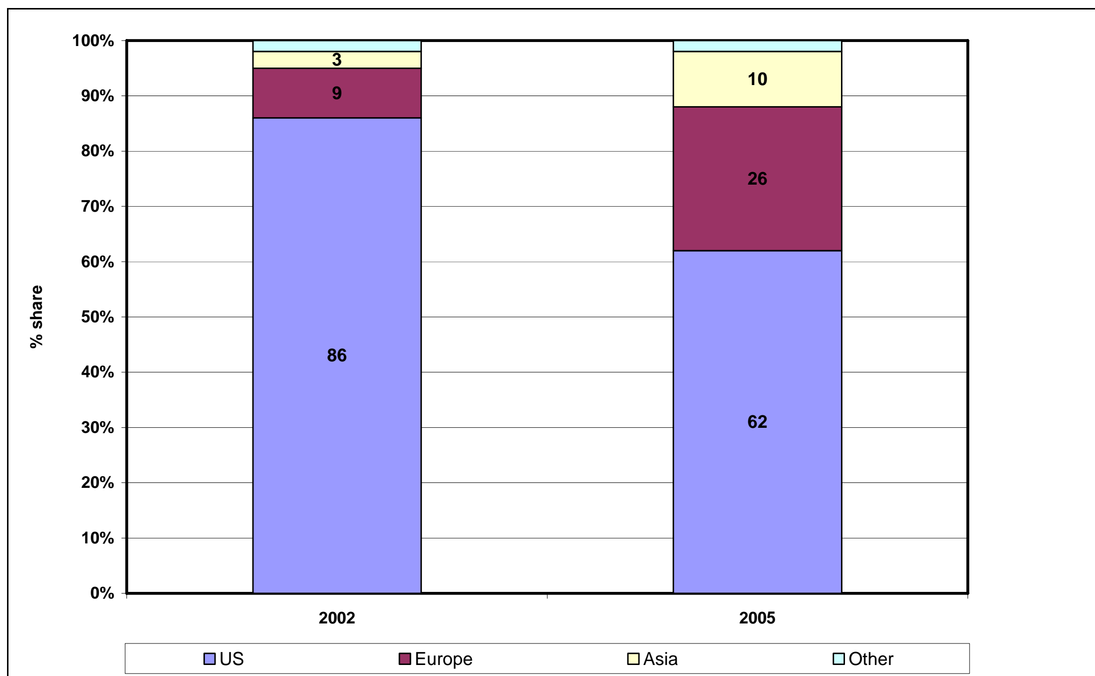
Figure 2. Domiciliation-management discrepancy to circumvent regulation



Source: TASS.

Thus, compared to the US hedge fund industry, the EU is yet at an earlier stage in its development. As Figure 3 emphasises, however, European investors increasingly depend on hedge funds. A recent survey by Mercer also shows that the European pension fund industry relies strongly on active manager strategies, and suggests that the industry's share of investment in hedge funds could rise by 5% over the next year.[3]

Figure 3. Source of investments in hedge funds, 2002 and 2005



Source: IFSL estimates based on EuroHedge, June 2005 data.

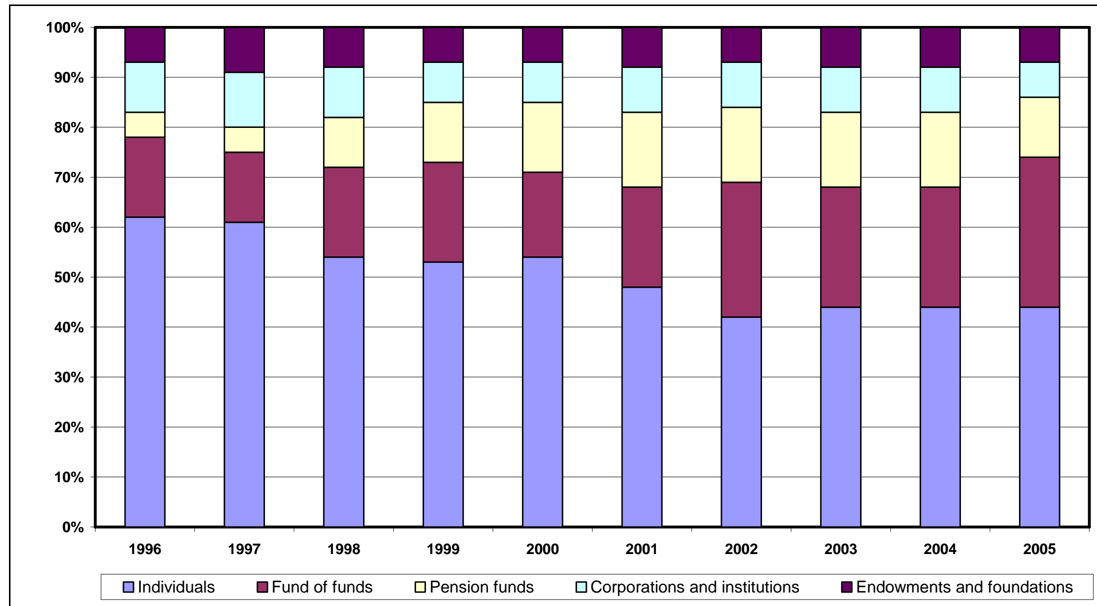
[3] Mercer's European Asset Allocation Survey (2006).

The absence of regulatory oversight has greatly fuelled inflows into the hedge fund industry. It has so far preserved a favourable regulatory environment by refraining from targeting the wider public and focusing on the delivery of investment services to qualified investors. By doing so, the industry managed its expansion without attracting too much attention from regulators, although the situation is changing.

Hedge funds under scrutiny by regulators

Hedge funds have evolved to become a 'more popular' financial instrument. In the past, they were mainly used to allocate the capital of high net-worth individuals, whereas nowadays the source of hedge funds capital has diversified and indirectly trickled down to 'median investors' via the intermediary of pension funds and funds of funds, which now make up 40% of the capital provided to hedge funds (see Figure 4).

Figure 4. Sources of capital of the hedge fund industry



Source: IFSL estimates based on EuroHedge and Hennessee Group data.

The success of funds of funds is attributable to three distinct factors. Firstly, their expertise on the hedge fund industry has enabled them to play the role of intermediary and discriminate risks that retail investors cannot assume. By pooling liquidity, funds of funds may potentially be able to gather more information on the hedge funds. From the governance perspective, however, the presence of funds of funds enables hedge funds to be insulated from pressures by corporate pension funds, and confers upon them a wider array of action.

Secondly, funds of funds offer investor the benefits of diversification as they traditionally invest in various hedge funds with different strategies. By doing so, funds of funds offer on average lower volatility than single hedge funds.

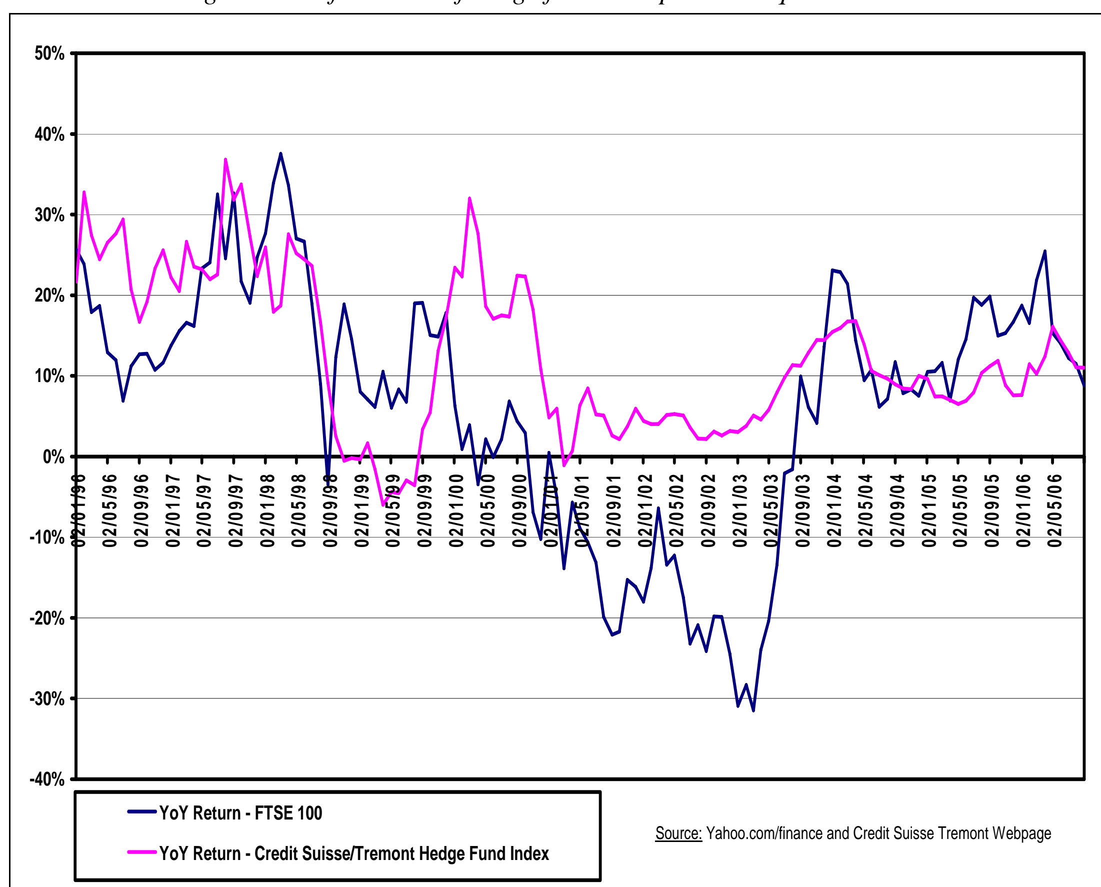
Thirdly, the observable institutionalisation of alternative investment funds is mainly the result of the hedge fund industry's track record. Pay-offs in the hedge fund industry have not for the time being correlated with stock market performance.[4] When the market has plummeted, they have proven to be less volatile (see Figure 5). This peculiar feature of the alternative investment industry has greatly contributed to the institutional interest (funds of funds, hedge funds, foundations, charities…) and consequently brought retail investors' wealth into the hands of hedge fund managers. The complementary risk profile of such products compared to the one offered by traditional investments allows the widening of the range of products offered to investors, who may consequently enhance risk diversification and attain a more optimal risk-return balance and lower overall return volatility.

Hence, funds of funds and pension funds capitalise on their expertise, the benefits of portfolio diversification, the circumvention of regulatory barriers that impede hedge funds from delivering services to retail investors, as well as the industry's tendency to not follow market downturns.

[4] CSFB Tremont indices show that the average return of hedge funds was 3% in 2002, while over this same year the FTSE100 dropped by 22.5%.

The observable shift in the profile of hedge funds' median investor raised regulators' concern. In fact, Germany has put hedge fund transparency on the agenda of its G-8 Presidency.[5] Regulators doubt that the current regulatory scheme enables retail investors to accurately assess the risk they are assuming when investing in funds of funds or pension funds, and have urged the industry to enhance transparency. The lightweight regulatory scheme that currently applies to the industry does not safeguard the interest of small investors, who face the greatest information asymmetry. It is precisely this increased exposure of smaller investors through pension funds that argues for either a limitation of the hedge fund industry's capital sources, which is difficult to screen, or for the establishment of a regulatory scheme. However, the peculiar nature of the hedge fund industry renders regulatory efforts highly questionable and could prove counterproductive due to the special nature of the industry.

Figure 5. Performance of hedge funds compared to equities markets



Regulatory implications: Market efficiency, investor protection and market stability

Empirical and theoretical papers sketch the efficiency gains that hedge funds have made on price formation mechanisms and on liquidity. A formal analysis by Biais, Bossaerts and Spatt (2005)[6] underlines the relative importance of efficient price signals for enhancing the efficient allocation of capital and facilitating less-informed investors to make the right portfolio choices. Hedge funds are often keen and creative arbitrageurs, with the ability to operate on all sectors/markets, thereby rendering their activity useful for ensuring accurate pricing across markets.

A recent study by Greenwich Associates emphasises that 45% of the annual trading volume in emerging market bonds and 47% of annual volume in distressed debt were generated by hedge funds.[7] Moreover, in the credit derivatives segment, hedge funds have proven to be delivering a great chunk of liquidity as they accounted for more than 55% of all credit derivatives' trading volume.[8] Therefore, hedge funds dominate the booming credit

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[5] Bertrand Benoit, "Fund transparency put on G8 agenda", *Financial Times*, 17 October 2006.

[6] B. Biais, P. Bossaerts and C. Spatt, "Equilibrium Asset Pricing and Portfolio Choice under Asymmetric Information", unpublished manuscript, revised 2005.

[7] Greenwich Associates – Press release 13 September 2006.

[8] Greenwich Associates – Press release 13 September 2006.

derivatives market, and by actively participating in them, hedge funds contribute to the more accurate and efficient management of counterparties' risk. Furthermore, hedge funds account for a great share of trading volume in the equity markets, in the convertible bond market and in the credit derivatives markets and hence provide tangible benefits, such as increased market efficiency, price discovery and most importantly liquidity for all investors.

Above all, the vital role hedge funds play in the credit derivatives market further puts the future of a market that has gained a prominent role in capital markets over the past decade in the hands of a few lightly-regulated actors. The increased regulation of banks and more recently of equity markets has further raised incentives to transfer risk towards unregulated institutions, such as hedge funds. As they also rely on credit lines given by banks, a hedge fund's default could easily backfire onto banks' balance sheets, and consequently increase systemic risk.

The sensible balance between retailing the market and adequate policy-making

The hedge fund industry needs to expand so that the efficiency gains can be maximised and the negative spillover on systemic risk minimised. Such an agenda is an ambitious and hardly achievable challenge for such a geographically-mobile and mostly offshore-concentrated industry. Nevertheless, as such funds grew tremendously over the past decade (see Figure 1) and are increasingly 'retailised', the regulatory framework of hedge funds should be adapted to the new shape of the industry and its enlarged investor base.

The large movement of capital into hedge funds was bound to attract the attention of regulators. The wider investor base, increased scope for systemic risk and the high dependence of some markets on hedge funds modify the landscape of the industry and require the adaptation of disclosure standards.

The natural opacity of hedge funds implies that enhancing disclosure via regulation in order to better protect smaller investors could sap the industry. Nevertheless, such "lack of public disclosure about the way hedge funds operate, the lack of standards …, the possibility for undisclosed conflicts of interest, the unusually high fees and indeed the higher risk that accompanies a hedge fund's expected higher returns, … make hedge funds risky ventures that simply don't make sense for most retail investors", argues SEC Commissioner Christopher Cox.[9] The downside of such regulatory steps, industry representatives emphasise, is reduced innovation, increased cost, adverse effects on the credit derivatives segment as well as the relocation of hedge funds to offshore jurisdictions. While readjusting the regulatory framework, regulators will have to bear in mind these constraints, as it might render any regulatory strengthening counterproductive. Thus, appropriateness as well as multilateral action by regulators are the crucial prerogatives to achieve an appropriate regulatory framework that contributes to attracting more investors by establishing disclosure/transparency standards, and would consequently strengthen the incentives of hedge funds to move/remain onshore.

Henceforth, the key challenge to be addressed is to set transparency principles that achieve a commensurate balance between disclosure of necessary information to investors and the protection of the hedge-fund managers' know-how. Precisely for this reason the regulation of hedge fund has to be indirect, i.e. through investor education and the regulation of counterparties and creditors.[10]

The bottom line for the sustainability of this industry should be for the funds to raise disclosure standards to enable retail investors to make educated decisions when investing. If the industry does not manage this step by itself, regulatory steps could follow that could be detrimental to the market as a whole, with funds being pushed offshore and investors losing the benefits of increased market efficiency and liquidity.

The current state-of-the-art in hedge-fund regulation

The state-of-the-art in the field of hedge-fund regulation pinpoints the flagrant divergence in countries' beliefs in market-based financial intermediation within Europe (see Table 1). However recent efforts by Germany, France and Ireland bridged these conceptual divergences and allowed for onshore hedge funds, i.e. funds of funds may be acquired by retail investors, whereas single hedge funds remain in the domain of high net-worth individuals.

Germany adopted a new regulatory approach towards hedge funds,[11] which conferred some slight impetus to its hedge fund industry in recent years. The French approach seems to have been most successful at luring hedge

[9] http://www.sec.gov/news/testimony/2006/ts072506cc.htm

[10] ECB, *Financial Stability Review*, Box 5, p. 46.

[11] The 2004 reform hamstrings hedge funds managers. German legislation requires the provision of transparency regarding the source of income and the distribution of revenues; moreover, it imposes strict taxation rules that impose strong disclosure requirements.

funds onshore. The regulatory framework conferred by the investment vehicles OPVCM and ARIA EL[12] have appropriately matched investors' and hedge funds' expectations, as France doubled its share of market funds and market assets over the 2000-04 period. Transferring the French experience to the EU level would boil down to erecting a UCITS-like, product-based framework for alternative investments and might serve as an example for European policy-makers. However such products-based regulation can be considered as a rapid cure, but they are not a long-term EU-wide solution as they are out of synchronisation with latest developments in financial innovation.[13]

In the United States, the SEC has taken a light approach to the regulation of hedge funds since 1982.[14] The intent to move towards a stronger regulatory burden for the registration of hedge funds by February 2006, in order to bring more transparency to the industry, was knocked down by the Court of Appeals in the Goldstein ruling.[15] Thus the carrot remains unchanged and hedge-fund actors encounter a risk-taker friendly environment. Nevertheless, the stick was made tougher with a stricter application of the prevailing rules to the hedge fund industry. In fact, the number of SEC enforcement cases brought towards hedge fund advisers has increased from 4 in 2001 to more than 90 since then.[16] Thus, the challenge for the SEC to go forward on the hedge fund regulation front is to know how to fill the gap left by the Goldstein ruling. Following the Amaranth bust in September 2006, SEC Commissioners seemed satisfied with the market reaction; as compared to LTCM the spillovers have been negligible. However, they are increasingly worried about pensioners' exposure to hedge funds and seem to be willing to modify the accredited investor definition, by raising annual income thresholds and minimum net worth of investors.

Table 1. Overview of national regulation of hedge funds in the EU

	Availability of hedge funds and fund of funds to investors							Distribution channels of hedge funds						
		Single strategy hedge fund			Fund of funds									
	Min. investment	Domestic	EU domiciliated	Other domiciles	Domestic	EU domiciliated	Other domiciles	Banks	Fund distribution companies	Via wrappers	Private placements	Investment managers	Other regulated financial services inst.	Non-regulated financial intermediaries
Austria	nil	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes			
Belgium	N/A	No	No	No	No	No	No	Yes		Yes	Yes			
Denmark	Variable	Yes	Yes	Yes	Yes	Yes	Yes	Yes			Yes	Yes		
Finland	nil	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes			Yes		
France	€10,000 for fund of fund ; €125,000 / €250,000 for single manager funds	Yes	Yes	Yes	Yes	Yes	Yes		Yes	Yes	Yes	Yes		
Germany	nil	Yes	Yes (only via private placement)	Yes (only via private placement)	Yes	Yes	Yes	Yes					Yes	Yes
Greece	N/A	No	Yes (only via private placement)	Yes (only via private placement)	No	Yes (only via private placement)	Yes (only via private placement)				Yes			
Ireland	€125,000/ €250,000 for single manager funds	Yes	Yes	Yes	Yes	Yes	Yes	Yes			Yes		Yes	
Italy	€ 500,000	Yes	No	No	Yes	No	No				Yes			
Luxembourg	nil	Yes	Yes	Yes	Yes	Yes	Yes	Yes					Yes	
Netherlands	nil	Yes	Yes	Yes	Yes	Yes	Yes			Yes		Yes	Yes	
Portugal	€15,000 / €30,000	Yes	Yes	Yes	Yes	Yes	Yes	Yes						
Spain	€ 50,000	Yes	Yes	Yes	Yes	Yes	Yes	Yes			Yes	Yes	Yes	
Sweden	nil	Yes	Yes	Possibly	Yes	Yes	Possibly	Yes				Yes	Yes	
UK	[£250-£250,000]	Yes	Yes	Yes	Yes	Yes	Yes	Yes		Yes	Yes	Yes		

Source: Based on PWC, *The regulation, taxation and distribution of hedge funds in Europe*, June 2006.

At the European level, no unified regulatory framework currently targets hedge funds (see Table 1). Hence, hedge fund managers do not benefit from any EU passport and are not able to market their products across Europe, which is the reason why hedge funds in the European Union are mostly located in the jurisdiction in which they are distributed. The greatest regulatory challenge for the Commission in this context is the increased reliance of investment funds on hedge fund techniques, which has blurred the distinction between asset management and alternative investment. The resolution adopted by the European Parliament in 2004 on hedge funds and derivatives[17] was an attempt to clarify this confusion. In essence, the resolution urges the Commission to consider the development of a light-weight, UCITS-like and product-based regulatory regime for SAIVs (sophisticated alternative investment vehicles).

Since then, with major regulatory steps such as MiFID and UCITS having been implemented, the European Commission long seemed to be *in expectatio* of the impact of those major regulatory changes prior to addressing

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[12] OPVCM à Règles d'Investissement allégées à Effets de Levier.

[13] J.-P. Casey, *Eligible assets, investment strategies and investor protection in light of modern portfolio theory: Towards a risk-based approach for UCITS*, ECMI Policy Brief No. 3, ECMI, Brussels.

[14] Jeremy Grant, "SEC to take a fresh look at hedge fund rules", *Financial Times*, 11 December 2006.

[15] Court of appeals' ruling that relinquished the registration prerogative of hedge funds proposed by the SEC.

[16] http://www.sec.gov/news/testimony/2006/ts072506cc.htm

[17] European Parliament resolution on the future of hedge funds and derivatives (2003/2082 (INI)).

the hedge fund industry. Then, in December 2006, as part of its mandate to monitor financial stability, the ECB came up with the initiative to establish an HLI (Highly Leveraged Institutions) position register,[18] i.e. a centralised information register on the portfolio composition of highly leveraged market actors. The theoretical construct proposed is rather clear and pertinent, but its implementation is vague at best. The urge to enhance transparency on the risk profile of hedge funds is to be commended, but an encompassing picture of the risk profile can only be achieved if all market participants are legally bound to disclose data. Moreover, given the global nature of the hedge fund industry, a complete picture of each hedge fund's risk profile can only be achieved if the register is pushed through multilateral policy-making.

More importantly, great regulatory uncertainty is currently looming over the impact of MiFID on the distribution of non-harmonised products such as hedge funds (non-UCITS products). The increased importance of such products raised pressures on the Commission to widen the definition of eligible assets, so that those products could benefit from a European passport. Such product-based approach is however outdated[19] and out of synchronisation with the current level of financial innovation. As a consequence, the industry has through the Expert Group report on alternative investments perceived in MiFID the opportunity to benefit from EU-wide distribution under MiFID conditions without imposing additional restrictions on the fund, or its manager. CESR perceives this scenario as highly unrealistic, as it would weaken the UCITS industry. In light of the regulatory debate on hedge funds, the MiFID-UCITS interaction needs to be addressed by the Commission, in particular as in how MiFID addresses the cross-border sales of non-harmonised products.

This regulatory issue reveals the importance of the investment industry for the 'internal market coherence'. The European picture on this issue is said to be 'in the pipeline', after the publication of the report by an expert group on the Alternative Investment Industry.[20] The recommendations of this report point towards the inappropriateness of further regulation, and more precisely to the potentially disruptive effect of regulating investment strategies. However, in light of efforts to fortify the single market for financial services, DG Markt intends to unify the regulatory patchwork on grounds that it hinders the efficient allocation and distribution of capital in Europe. The overall lack of agreement on the need to build a specifically European legal framework for the entire hedge fund industry will probably result in the introduction of oversight through investment managers. Instead of imposing a UCITS-like, product-focused regulation, regulators will likely agree on a set of pan-European rules that will shift the regulatory burden towards investment managers as will be the case under MiFID.

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[18] See ECB, *Financial Stability Review*, December 2006 – Box 5.

[19] J-P Casey, *Eligible assets, investment strategies and investor protection in light of modern portfolio theory: Towards a risk-based approach for UCITS*, ECMI Policy Brief No. 3, ECMI, September 2006.

[20] Report of the Alternative Investment Expert Group.

About ECMI

The European Capital Markets Institute (ECMI) was established as an independent non-profit organisation in October 1993, in a collaborative effort by the European Federation of Financial Analysts Societies (EFFAS), the Federation of European Securities Exchanges (FESE) and the International Securities Market Association (ISMA), now the International Capital Market Association (ICMA). ECMI is managed and staffed by the Centre for European Policy Studies (CEPS) in Brussels. Its membership is composed of private firms, regulatory authorities and university institutes.

European capital markets have experienced rapid growth in recent years, corresponding to the gradual shift away from relationship banking as a source of funding and at the same time, have had to absorb and implement the massive output of EU-level regulation required to create a single market for financial services. These developments, combined with the immense challenges presented to European financial institutions by the globalisation of financial markets, highlight the importance of an independent entity to undertake and disseminate research on European capital markets.

The principal objective of ECMI is therefore to provide a forum in which market participants, policy-makers and academics alike can exchange ideas and opinions concerning the efficiency, stability, liquidity, integrity, fairness and competitiveness of European capital markets and discuss the latest market trends. These exchanges are fuelled by the publications ECMI regularly produces for its members: quarterly newsletters, annual reports, a statistical package, regular commentary and research papers, as well as occasional workshops and conferences. ECMI also advises European regulators on policy-related matters, acts as a focal point for interaction between academic research, market sentiment and the policy-making process, and promotes a multidisciplinary and multidimensional approach to the subject.

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