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Transparency and Conflict of Interest

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TABLE OF CONTENTS

Executive Summary **iii**

1. **Introduction** 01
   - 1.1 Background to this Report 02
   - 1.2 Definitions of Hedge Funds 03
   - 1.3 Growth of the Hedge Fund Industry 04
   - 1.4 What explanations are given for the Industry's Growth? 04
2. **Transparency of Hedge Funds for Investors** **06**
   - 2.1 Introduction 06
   - 2.2 Qualifying Investors 06
   - 2.3 How well informed are Investors in Hedge Funds? 07
   - 2.4 Does Lack of Transparency lead to Higher Operational Risk? 08
   - 2.5 Arguments against Disclosure of Positions 09
   - 2.6 Managed Account Platforms 10
   - 2.7 Other Transparency Issues 11
   - 2.8 Earlier Guidance on Risk Disclosure 11
   - 2.9 More Recent Guidance on Best Practice and Codes of Conduct 13
   - 2.10 Recommendations 14
3. **Retailisation** **18**
   - 3.1 Current Regulatory Practices 18
   - 3.2 Anomalies in Current Regulatory Practice 18
   - 3.3 Retailisation via Structured Notes 20
   - 3.4 Retail Exposure via Pension Funds and Insurance Companies 21
   - 3.5 Conclusions on Retailisation 231
4. **Shareholder Activism and Other Transparency Issues** **24**
   - 4.1 Other Transparency Issues 24
   - 4.2 Beneficial Interests in Hedge Funds 24
   - 4.3 Ownership of the Management Company 25
   - 4.4 Shareholder Activism and the Transparency of Interests in a Target Company'sSecurities 25
     - 4.4.1 Definition of Activism 25
     - 4.4.2 The Opportunities Created by lax Corporate Governance 26
     - 4.4.3 The Separation of Economic and Ownership Rights 27
     - 4.4.4 Joint Action/Acting in Concert by Hedge Funds 29
5. **Insider Dealing** **30**
   - 5.1 Definition 30
   - 5.2 Hedge Fund Involvement 30
   - 5.3 Hedge Funds as Providers of Capital in Primary Securities Markets 30
   - 5.4 Hedge Funds and Insider Trading: Recommendations 31
     - 5.4.1 Compliance Culture within Hedge Fund Management Companies 32

6. **Other Conflicts of Interest** **33**

6.1 Side Letters 33

6.1.1 Differences in Materiality 33

6.1.2 Disclosure Practices 34

6.2 Valuation Practices 35

6.3 Conflicts of Interest in the Fair Allocation of Trades 36

6.4 Conflicts of Interest among Service Providers 36

6.5 Conflicts of Interest: a Conclusion 36

7. **Summary of Recommendations** **38**

7.1 Transparency 38

7.2 Retailisation 39

7.3 Shareholder Activism 39

7.4 Insider Dealing 39

7.5 Other Conflicts of Interest 39

Bibliography **40**

Annexes

1. Growth and Distribution of Hedge Fund Assets 45

2. European Union Council Press Release on Hedge Funds and Financial Stability 46

3. Extract on Disclosure in the CFA Code of Conduct for Asset Managers 47

4. Terms of Reference for the European Commission Expert Working Group 48

5. Alternative Means of Investing in Hedge Funds 49

6. Overview of National Regulatory Regimes 50

7. Investor Restrictions in Hedge Fund Investments: Varying Treatments 51

8. EDHEC Report on the Quantified Risk of Hedge Funds 52

9. Transactions with Differential Voting and Economic Interests 53

EXECUTIVE SUMMARY

The hedge fund industry has risen in 2007 to the top of the international political agenda, yet the debate surrounding it is limited by a lack of understanding of how the industry functions, or even how it is to be defined. The industry consists largely of investment funds operating from offshore locations, especially the Cayman Islands, for reasons of tax, but also because the disclosure requirements are low. Thus the industry has acquired a reputation for tax 'shyness' coupled with a tendency towards secretiveness. At the same time, the industry has grown rapidly and now controls, it is estimated, close to €2 trillion of assets. Understandably this combination of rapid growth and a lack of transparency have caused unease within European business and political circles.

European investors – both institutional and individual – have contributed to the growth of assets; therefore the hedge fund industry must be perceived as providing benefits that are not available from the traditional investment industry, and which overcome investor concerns arising from high fees and lower reporting transparency. Furthermore this demand has occurred against a background of regulatory restrictions that seek to discourage investment in offshore funds.

As more traditional managers have used hedge fund techniques, or introduced hedge funds themselves, we have seen a growing convergence between the onshore and offshore investment management industry's practices. However, we argue in our report that the hedge fund industry's lack of transparency and seemingly high fees may be prolonged precisely because the EU's complex regulations *lessen* any commercial pressure to meet onshore standards. Certainly some in the hedge fund industry are perfectly content with the status quo.

Our principal recommendation is that in preference to more stringent regulation, the industry should adopt a rigorous voluntary code of conduct covering disclosure, valuation, and internal governance procedures. Secondly, for any such code to be taken seriously by investors, regulators and the public at large, adherence to it should be subject to independent verification, for example by the hedge fund's auditors.

Thirdly, we argue that any such code would be ignored by large parts of the hedge fund industry if there are no regulatory incentives for the industry to adopt it, for example in the form of the relaxation of existing barriers to market access for those complying. We argue that only in this way can the objectives of investor protection within the European Union be achieved without expensive and inefficient extensions to existing regulations.

None of these proposals has great utility in bringing about investor protection if taken in isolation; only if taken together, as a package, can they have their desired effect.

Transparency

Four possible ways in which EU regulators could bring about greater convergence between onshore and offshore fund practice are:

a) Introduce more stringent legislation to reduce access to a European clientele by offshore funds,

b) Reduce or amend EU legislation, so that the onshore investment management industry can deliver services to clients that are equivalent or superior to the offshore product,

c) Wait for – or encourage – commercial private sector competitive forces to bring about convergence, as is slowly happening, and finally

d) Encourage industry guidance on standards and voluntary codes of conduct that embrace the highest ethical standards of practice, to apply to all parts of the industry.

Of these four solutions, the first, namely more stringent legislation of offshore funds, is probably counter-productive, and not likely to be an efficient means of bringing about greater availability of investment products that are attractive to clients and fairly priced. Indeed although we make in our report a number of recommendations for changes in legislation, it is difficult to see how generally more restrictive legislation on access by investors would do anything but preserve the status quo for existing hedge fund managers.

All of the three remaining solutions are likely to contribute to a more integrated - indeed a more 'onshore' - industry. We already see important developments in the onshore industry that arise from UCITS III's relaxations of former restrictions on retail funds. This policy of "stealing the oppositions' clothes" could be carefully encouraged.

Our major recommendation here concerns multi-strategy and funds of hedge funds (FoHFs). The recommendation is that policy makers should provide regulatory incentives to bring onshore any funds that meet certain defined diversification criteria. Subject to meeting the diversification criteria, they should be permitted in our view to use any underlying investment fund that complies with an industry-agreed disclosure code covering its portfolio's risk and other characteristics. Finally, compliance by the underlying fund – which itself might be offshore - with the industry code of practice should be audited annually by the fund's auditing firm, and reported as such in its annual report. The transparency requirements we envisage would require regular updating by monthly, or at least quarterly, shareholder newsletters.

Our purpose here is to drive a wedge between the high risk single strategy hedge fund, which should continue to be restricted to qualifying investors, and the lower risk FoHFs and similar vehicles, which are subject to MiFiD, MAD, UCITS III and other EU legislation. The combination of these laws and professional oversight by the FoHF manager, together with the transparency requirements we recommend, are in our opinion sufficient to provide the necessary framework of investor protection, or indeed to improve the existing level of protection.

It would be desirable in our opinion for the Committee of European Securities Regulators (CESR) to re-visit its existing 'look-through' provisions in UCITS III, which withholds UCITS III status from any fund whose holdings are not themselves UCITS III compliant. If this is not possible, then we propose that regulators work towards bilateral recognition of each other's regimes as they pertain to the cross border marketing of non-harmonized investment product. This would however be a second best solution.

Retailisation

The European and national regulations governing direct and indirect access by retail investors to hedge fund and hedge-fund-like products are fragmented. They suit none of the so-called 'stakeholders'. We identify in our report a number of anomalies, beginning with the fact that retail clients lost substantial proportions of their assets in highly regulated products in the bear market earlier in the decade, yet cannot freely purchase investment products that are demonstrably more secure and better diversified. Secondly, FoHFs can now be purchased in their closed-end form on stock exchanges, yet cannot be sold in their open-ended form. Thirdly, we note that a qualified investor is defined as a wealthy individual, who can buy into any kind of hedge fund, while highly qualified and professionally accredited investment managers under the supervision of their local regulator remain heavily restricted in terms of the kind of product they can sell. We note also that what can be bought or sold very much depends on where the investor is domiciled, and that major differences exist between jurisdictions, that appear difficult to justify.

Collectively no stakeholder is well served by the wide variety of regulations that consumers and providers currently face in different countries within the EU.

We draw attention under this heading to the rapid growth of onshore investment products that either are hedge funds, or resemble them closely, that are already marketed to retail investors. These would include structured products, closed-end funds, and some absolute return funds. Their commercial success signals to us that demand for hedge-fund-like investments remains strong. We believe that our earlier proposals can address the investor protection concerns, and that therefore the range of products available to EU clients should be expanded by relaxation of the existing legislation. This would introduce additional and healthy competition to the market.

Finally, in order to address the concern about the potentially high cost of bringing hedge funds to retail investors, we believe that each product should clearly indicate the total fees paid by the investor while investing in the product. Since some of the fees depend on the level of return, the product should specify the level of fees an investor pays for earning a (gross of all fees) return of, say, 1%, 5%, 10% and 15%.

Shareholder Activism

Activism is a by-product of lax corporate governance by onshore investment managers. Opportunities for activists arise because traditional investors have failed to discipline company managers to act in shareholders' interest. Although a few hedge funds have become involved in activism, there seems to be nothing particular about their role that distinguishes them from private equity funds or the relatively small number of large pension funds that pay greater attention to their duties as owners. Unlike private equity firms that target weakly governed firms, hedge funds usually leave their targets in the more transparent environment of quoted companies. In our opinion, such outcomes are preferable.

There is legitimate concern about hedge funds exploiting the separation of economic and voting rights. We argue that derivative positions, long and short, should be aggregated for reporting purposes with other forms of interest in a company, such as traditional shareholdings.

The alarm has been raised by instances where hedge funds simultaneously benefited from a share price fall – on account of a net short economic position – while successfully exercising votes at a general meeting of shareholders. In our view, the stock lenders who facilitated these instances should in retrospect have charged more for their votes. At the same time we argue for improvements in the transparency of the stock lending market, greater pressure on investment managers and their clients to vote their shareholdings at all shareholder meetings, and greater disclosure of net economic exposure while voting.

Insider Dealing

There does appear to be evidence of market abuse by some hedge funds in both equity and debt markets. Hedge funds are likely to be involved more frequently than one may otherwise expect because their very flexibility enables them to operate as both lenders and investors, and therefore to pierce Chinese walls. Their familiarity with both derivative and public security traded markets adds further to their ability to operate outside the law. Proof of insider dealing remains elusive, however.

We make a number of recommendations. Firstly the EU should follow the United States (US) example and consider constructing a giant 'data warehouse' similar to the US Depositary Trust's Company's database of credit default swaps contracts. The EU should consider how far the idea could be extended to all OTC derivative markets. Secondly, regulators throughout the EU, investors, and managers should all consider the effectiveness of hedge funds' internal compliance procedures for minimizing market abuse risks. If there is to be an effective voluntary code, it must clearly be especially rigorous with respect to monitoring of potential market abuse.

Thirdly, all EU regulators could put teeth into the voluntary proposals by regularly testing managers within their jurisdictions against 'best practice' codes during their monitoring visits.

Other Conflicts of Interest

We believe that so-called 'side letters' raise important concerns about potential conflicts of interest. Hedge funds currently negotiate bilaterally with larger investors. Sometimes they offer larger investors both greater disclosure and earlier redemption facilities. We believe that these arrangements can be unfair on smaller investors, who are potentially the victims of something akin to insider trading. We make specific recommendations regarding disclosure of side letters to all investors.

The second area we discuss is valuation procedures. It appears at the global level that some biased valuation does exist. We suggest that regulators should investigate this area, as it is one form of fraudulent behaviour. We believe more attention should be paid to issues concerning the segregation of duties, and better governance at the fund level.

The third area where hedge funds are likely to find themselves in a conflict-of-interest situation concerns the fair allocation of trades. Again, the remedies are likely to involve better internal compliance, accompanied by closer surveillance by the relevant national authorities of the practices of hedge fund management firms.

Conclusion

We believe that there are some relatively simple moves that the industry and its regulators could make that would address the concerns raised within European business and political circles. If followed, these recommendations would address investor protection needs, serve the EU consumer, and create efficiencies and greater competition within the industry

In closing, we would add that hedge funds do not exist in isolation. They are deeply integrated into a financial industry that is developing and innovating continuously. In calling for tighter regulation of hedge funds we believe that many observers are attacking a specific type of investment ***vehicle***, and not the ***activity*** which gives rise to the concern, an activity that in all probability is being performed by many other parties – such as proprietary trading desks of investment banks - that are not hedge funds.

A knowledgeable author ([1]) reminds us of the cartoon series "The Simpsons". In one episode, a meteor strikes the town of Springfield, causing widespread damage. In response the survivors march on the town hall demanding the closure of the local observatory.

[1] *"A Demon of our own Design: Markets, Hedge Funds, and the Perils of Financial Innovation"* by Richard Bookstaber, John Wiley & Sons Inc, 2007, page 257

1. INTRODUCTION

1.1 Background to this report

This report is intended to provide external independent expertise to members of the European Parliament and in particular to its Committee on Economic and Monetary Affairs for their discussions on hedge funds. We have been invited to address the issues of transparency, retailisation, insider trading and other conflicts of interest.

The invitation to write this report arises from a number of developments, which we cover briefly as background material in this Introduction. Firstly, hedge funds have grown in size and in their influence on investment markets during the last ten years. Secondly, they remain poorly understood by the media, regulators, legislators, other investors, the public at large, and not least by the management and employees of investee companies, i.e. those companies that hedge funds target as investments. This situation, combined with their offshore status and the opaque nature of their activities, has understandably given rise to calls for greater transparency to be imposed on the industry. Furthermore, the industry does not yet have a significant retail investor base, but it appears to be growing, and it is in the retail area of the investment industry that European legislation regarding transparency is usually targeted.

Thus a dilemma arises; on the one hand the industry has established itself outside the onshore regulatory framework that could quickly and easily impose transparency requirements, yet there is no clear understanding of how those regulations could be extended to cover hedge funds. This situation is sub-optimal for almost all parties: retail investors throughout Europe are denied access to investment products that are clearly of interest to high net worth investors and institutions; hedge funds themselves have limited expansion opportunities; investee companies continue to feel threatened by this new type of investor, and lastly traditional investment management firms are threatened by market-share loss and possibly by a heightened risk of market manipulation and abuse within security markets. Regulators meanwhile continue to express their general concerns about the impact of hedge funds on the stability of financial markets and on investor protection issues.

This report is intended to help evaluate proposed solutions to this dilemma, and to raise the level of understanding both of the issues and of the proposed solutions. This Introduction discusses the difficulty of defining a hedge fund and puts the growth of hedge funds into the context of quoted securities markets.

Chapters 2 and 3 following this Introduction are related: they examine transparency from the investor point of view. Chapter 2 describes current practice, and compares it with the regulated onshore industry's reporting requirements under UCITS III. The lack of transparency surrounding what hedge funds own extends also to who owns the units of their funds, and who owns the management companies that manage them.

These latter concerns are addressed briefly in Chapter 4 of this report. There may be a case for disclosure of entities investing in hedge funds, just as there is pressure from some quarters to disclose the backers of private equity funds[1]. However, there is no reason why hedge funds should be singled out for disclosure of those who have an interest in their funds, or in their management firms. This suggestion would therefore need wider debate, covering all funds, onshore and offshore. As the focus of this report is on the transparency of hedge fund reporting and related issues, we do not address here these other issues.

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[1] See for example the *Walker Working Group on Disclosure and Transparency in the Private Equity Industry*, established by the British Venture capital Association, 2007.

In Chapter 4 we move to the other major complaint about hedge funds, namely that the boards and management of investee companies assert from time to time that they are unable to establish with confidence the structure of ownership of their company's issued share capital. Again, it is argued that this arises because of a lack of transparency in, and poor reporting of, shareholdings by hedge funds[2]. Indeed these concerns extend beyond their shareholdings to include complaints about opaqueness of their positions in debt securities or in their derivative positions. Although the EU's Transparency Directive became effective in 2007, transparency in regard to notification of major shareholdings continues to vary widely; a company's management in the UK is able under the Companies Act 2006, Chapter 793 (Notices to Disclose Interest in a Company's Shares) to 'drill down' beyond the nominees shown on the register to discover the beneficial ownership of their company's shares. Whether reciprocity exists across borders in these shareholder disclosure laws is not clear. A British company may be able to force disclosure of beneficial interests on British owners – of any size position – but not on foreign holders, and vice-versa.

This discussion of shareholder interests leads into Chapters 5 and 6, which examine the evidence of insider trading and other conflicts of interest, before we summarize our conclusions in Chapter 7.

1.2 Definitions of Hedge Funds

There is no legal or regulatory definition of a hedge fund, and indeed some commentators believe that without a useful definition, much of the debate is futile. For example, Richard Bookstaber writes *"I believe that much of what is proposed for hedge fund oversight and analysis will turn out to be a fruitless exercise because the concept of a hedge fund defies meaningful definition."*[3] The International Organisation of Security Commissions (IOSCO) in its November 2006 report took a similar view, noting that "*no jurisdiction has adopted a formal legal definition of what is a hedge fund ... yet regulation of hedge funds has become a priority for a large number of jurisdictions.*"

In one sense, these views are overly pessimistic: while hedge funds are indeed heterogeneous in terms of size, investment strategy, location and management arrangements, and they are difficult to define, we recognize them when we see them. The following differences between traditional investment funds and hedge funds are often quoted.

Hedge funds typically:

- hold both long and short positions in securities, but are not necessarily hedged
- Are leveraged
- Have a high, performance-based fee in addition to a fixed fee structure
- Normally involve co-investment by the fund manager
- Have a broad investment universe and are able to use futures and other derivatives, including both exchange-traded and over-the-counter contracts,
- Can have large cash allocations
- Have an absolute return objective, such as LIBOR+ x% or y times LIBOR

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[2] For example, see Seifert, Werner G. and Voth, Hans-Joachim, *"Invasion der Heuschrecken: Wie Hedge Fonds die Deutscland AG attackieren"*, published by Econ, 2006

[3] From Bookstaber, Richard, *"A Demon of our own Design: Markets, Hedge Funds, and the Perils of Financial Innovation"*, John Wiley & Sons Inc, 2007, p244.

- May lock in investors for extended periods, e.g. two years, and can impose impediments to capital withdrawals, including suspension of redemption rights
- Have limited investment capacity and often "close" to new investments or new investors
- are lightly regulated with limited transparency or disclosure
- are often managed by unlisted private partnerships
  Traditional funds by contrast, through choice or regulation, in general
- Invest long only
- Are not leveraged
- Typically have a lower ad valorem fee structure
- Do not insist on co-investment
- Are restricted in using derivatives
- Often have a limited investment universe, consisting mainly of listed securities
- Are required to stay close to fully invested
- Have a benchmark relative return objective
- Provide regular and frequent redemption opportunities, often daily
- Have large investment capacity and usually always remain "open" to new investments
- Are frequently heavily regulated with greater transparency and disclosure
- Are often managed by large financial service companies

In both cases, the investment manager is the agent of the investor, who in principal / agency theory is the principal. However the contracts between the principal and agent differ markedly. Thus the investor in traditional funds restricts the freedom of the manager and demands greater transparency, but does not insist on co-investment. The traditional investor also expects the manager to stay relatively close to the benchmark, and accepts the risks associated with the benchmarked asset class, for example equity market risk.

By contrast, the hedge fund investor's contract with the manager calls for co-investment and provides significant incentive fees, but then provides the manager with much more freedom to be opportunistic, while exonerating him or her from reporting or redemption opportunities.

Neither model is intrinsically preferable or superior to the other. They are simply different. Furthermore, there is growing convergence between the onshore and offshore investment management industries. We discuss this development in greater detail below, under the heading of retailisation.

1.3 Growth of the Hedge Fund Industry

Hedge funds as a group are continuing to grow rapidly according to industry sources. Hedgefundweek.com, an industry intelligence site, issued a report dated October 2007 suggesting that hedge funds globally had reached $2.5 trillion under management by June 2007, up 19% since the end of 2006. The same firm quoted average performance to be in the region of 6% in the same period. This suggests that new inflows account for the majority of growth in assets under management, and testifies to the perceived attraction of this type of investment fund.

However, one needs to treat with care all estimates of the industry's size and growth. Annex 1 reproduces a chart based on Hedge Fund Research data, showing somewhat lower assets under management but very rapid growth since 1990. At London Business School we have researched many commercially available hedge fund databases and find numerous discrepancies, for example double counting and gaps in reporting which reflect the vendors' strengths and weaknesses in various geographic regions, or differences in definition. Hedge funds are not obliged to co-operate in any data-gathering venture and, if closed to new subscriptions, have little commercial interest in reporting to data vendors. Finally, data vendors provide only limited performance and basic administrative data and virtually all other "fundamental" (business, operational) data is missing.

Generally, efforts to reach a better understanding of the industry's structure and growth are to be encouraged. Due to lack of data classification standards, aggregated figures are unreliable whether they purport to show total number of funds, their operational status, their assets under management, their declared investment strategy, or their capital flows.[4]

It is also difficult, though less so, to estimate the market capitalization of all outstanding issues of quoted securities, but we need to make some estimate in order to place the asset base of hedge funds into a broader context. From various sources we estimate that the combined market capitalization of quoted equity and debt markets – globally – is of the order of $80 trillion, split roughly 40% in equities and 60% in debt securities. Thus assets managed by hedge funds amount to perhaps 3%. Such figures may understate their influence however. Hedge funds reputedly trade more actively than traditional funds, use leverage to increase their exposure, and are more aggressive when involved in shareholder activism.

Annex 1 also contains information in chart form showing the location of the largest hedge fund management firms and the extent of concentration in the industry. In brief, hedge fund management remains a predominantly Anglo-Saxon activity, with the US managing two dollars out of three of the industry's assets, and London dominating the European industry in terms of choice of manager location. Even in the Far East, Australia is the main centre for hedge fund management. Commercial databases of hedge fund activity indicate over 5,000 hedge funds in existence, most of them managed by 'boutique' firms managing assets of less than €100 million. About 370 firms with at least US $1 billion manage three quarters of the industry's assets. Furthermore these larger firms appear to be gaining market share.

The debate over the effects of the industry's influence on the financial system has been clouded therefore by the absence of any agreed definitions and the absence of reliable statistics on the industry's size and rate of growth.

1.4 What Explanations are given for the Industry's Growth?

Notwithstanding the lack of reliable data, it is clear that the industry is growing rapidly, and it may be useful for participants in the debate to share some of the reasons for that growth. We list a number of reasons below.

1. Evidence of ability to provide high absolute returns: Fung, Hsieh, Naik and Ramadorai (2007) report that fund of hedge funds provided statistically significant alpha[5] for a period in the late 1990s. This experience preceded and probably encouraged inflows into hedge funds during the current decade.

[4] Hence « professional » hedge fund investors such as Funds of Hedge Funds have created over many years their own proprietary databases of hedge fund management company history, usually through expensive "due diligence".

[5] Alpha can be interpreted as management skill, or risk adjusted returns. It is typically contrasted with beta returns which are those obtained by holding a broadly diversified portfolio such as an index fund.

2. The bear market in equities from 2000 to 2003: the current generation of European investors has experienced high volatility so far this decade in their equity portfolios, with indices halving on average in the earlier years, and recovering in more recent years. Unsurprisingly there has been considerable interest in any product that can offer absolute returns or a capital guarantee. Since the performance benchmark for a hedge fund is often the return on cash, or zero, hedge funds and fund of hedge funds are perceived as absolute return vehicles, and are therefore attractive.
3. Unbundling of alpha and beta returns: many traditional managers offer a hybrid product that combines exposure to an asset class, such as European equities, together with a manager's stock selection or timing skill. However, investment consultants and advisors are increasingly conscious that index funds can deliver asset class returns (beta) cheaply and efficiently. Those advisors also realize that for any given level of manager skill, the alpha that can be captured by the manager will be lower if the manager is constrained only to hold long positions. Generally, for any level of skill any constraint will lower the achieved return. Since hedge fund managers are much less constrained, their ability to add value is correspondingly higher, and investors realize this.

   Many institutional investors, such as pension funds, found through asset-liability modelling that their risk budget was excessively concentrated in their equity exposures. Hedge funds facilitate the efficient use of an investor's risk budget by unbundling of the two types of return into separate investment products. Skill-based returns can at least in theory be obtained without the addition of further equity risk. Similar arguments would apply to fixed income strategies.
4. Alternative betas and uncorrelated returns: investors are familiar with the concept of an equity risk premium in equities and a default risk premium in their fixed income portfolios. Academics however have identified further sources of systematic risk, now known as alternative beta. Examples are illiquidity risk – the premium obtained by sacrificing liquidity in a holding; complexity risk – certain types of security such as convertible bonds are hard to value for most investors, and earn a complexity premium. Other point to a premium obtainable on distressed securities, or on small companies.

   Hedge funds are often established to manage and exploit these alternative beta risk premium phenomena. Apart from the systematic risks mentioned, in a number of hedge fund strategies hedge funds are supplying a form of insurance product, for example in the merger arbitrage strategy, where they often 'underwrite' an offer to existing holders of the target company by buying securities of the target after the bidder's announcement. Hedge funds also provide investors with exposure to exotic risks such as currency or commodity speculation.

   Many of the returns from these hedge fund strategies are less than perfectly correlated or uncorrelated with conventional beta risks. Investment consultants find that such risks can be accommodated within the overall risk budget, because they are not perfectly correlated with existing (traditional) investments, and thus look favourably on their inclusion within an institution's overall investment policy.
5. Hedge fund fees are too low: This suggestion seems to run so much counter to perceived wisdom that it needs some explanation. Firstly, investors are not in general fools, yet demand for hedge funds continues to grow. Simplistically therefore, hedge fund managers appear to be underpricing their services. Secondly, traditional managers other than index fund providers deliver stock selection skills alongside beta risk, or exposure to the asset class. Since the latter risk is available at almost no cost to institutional investors, the *effective* price of the manager's stock selection skill could potentially be even higher than the fees on hedge funds.

2. TRANSPARENCY OF HEDGE FUNDS FOR INVESTORS.

2.1 Introduction

The number of European investors exposed in one way or another to hedge funds is likely to be growing rapidly in light of the statistics presented in Chapter 1. Regulators must therefore be concerned with issues of investor protection, and an important supporting plank of investor protection - it is often argued - is that investors or their advisors should be well-informed about the investments they make, and the risks assumed. Greater transparency, it is believed, will lead to greater investor participation, and greater participation by informed investors leads to better market disciplining of product providers, greater informational efficiency in markets and the more rapid spread of financial innovations. The questions of investor protection, participation, market discipline, and transparency are all therefore linked.

However, discussions of transparency are often clouded by a three dimensional sub-division of the topic, namely:

- Of what? Should we demand greater transparency of hedge fund **positions,** for example, or of the investment **risks** they incur**?**
- To whom? If improved disclosure is needed, is it to **investors**, to **counterparties,** such as prime brokers, bank, and administrators, or to **regulators**?
- By whom? Is it more productive for policy makers to focus on disclosure practices of **individual hedge funds**, or on **intermediaries** such as prime brokers or funds of hedge funds?

We argue in this chapter that in general investors in hedge funds are often ***not*** well informed relative to onshore investors in traditional funds, and that this arises principally from a lack of transparency regarding the investment positions, risks, or both, in the underlying offshore hedge funds. We also argue however that attaining full transparency, comparable with onshore reporting requirements, may be neither desirable nor practicable. Instead we make proposals here regarding improved risk disclosures by intermediaries to end investors. We believe that some modest but achievable changes could be implemented by regulators that would contribute to improved investor protection.

These proposals rely on the existence of a satisfactory voluntary code of practice – which we do not believe yet exists. Before turning to the topic of voluntary codes, we ask a number of questions about the role of qualifying investors, how well investors are informed today, the connection between transparency and operational risk, and technical issues in the aggregation of risk measures at the portfolio level.

2.2 Qualifying Investors

Most European jurisdictions have adopted the concept of a "qualifying investor" (the term "qualified investor" also exists) to denote an institution deemed to have sufficient resources that it does not need protection, or an individual investor who - when entering into a private placement arrangement - is classified by the product distributor to be of sufficient means that he or she is exempt from the rules that would otherwise apply in that jurisdiction. Normally the relevant definition is the minimum amount that can be invested. The rules vary widely from country to country; for example in Italy, a very high minimum of €500,000 applies for direct investment in hedge funds. The same high minimum applies equally to funds of hedge funds (henceforth FoHFs).

In other countries, the minimum amounts are lower, sometimes much lower, and furthermore a distinction is made in many jurisdictions between an individual hedge fund and a FoHF.

Legislation also exists on the manner of distribution, the extent of leverage, the number of subscribers and other aspects of the contract between the investor and the product supplier. Together the many differences, sometimes trivial and sometimes not, between these national regulations significantly hamper the development of an efficient distribution network in these products, and in particular, reduce the potential efficiencies of scale that the investment management industry could otherwise achieve in Europe.

Qualifying investors have been the main "early adopters" of hedge fund product, much as one hundred years ago wealthy individuals were the buyers of motor cars. As such they have played and continue to play an important role in the industry's development. For the purposes of the debate on transparency however, we believe that the main focus should be elsewhere - on retail and institutional investors, because it is here that the issues of investor protection arise.

2.3 How well informed are investors in hedge funds?

A large number of investors will be indirectly exposed to hedge funds through their interest in pension funds or life funds that decide to invest a portion of their assets in hedge funds. For example, German pension funds are reputed to have between 2 and 3% of their asset base in hedge funds([6]). The consulting firm Mercer reports that 13% of continental pension funds use hedge funds, against 7% in the UK([7]). The same report also makes mention of increasing intentions to invest further in alternative asset classes such as hedge funds.

In building their exposure to hedge funds, these institutional investors will not normally invest directly in individual funds, but will appoint further intermediaries such as multi-manager funds or FoHFs. Some individuals may invest in a quoted closed-end vehicle([8]), but these will again be a form of FoHF. Approximately €14 billion of such vehicles are currently quoted on the London Stock Exchange. A retail investor who buys shares in a quoted closed-end fund is investing in one of the more direct forms of hedge fund ownership, but in the annual report he or she will only see the names of the underlying funds, with a brief description of their strategies. The investor will not see individual holdings.

Since hedge funds cannot normally offer their shares to unqualified individual investors, and since the wealthy investors who can invest, do not (usually) see details of their funds' holdings, and cannot insist on disclosure, the result is that only investment professionals acting for intermediaries such as FoHF managers, and not all of them, get to see the detail of hedge fund portfolios. Disclosure is both voluntary and negotiable; a large pension fund or FoHF can negotiate greater disclosure than a smaller investor. Many hedge funds will resist detailed disclosure unless incentivised to provide it by the promise of greater investments in their funds, and will use transparency therefore merely as a negotiating tool.

We believe that the current situation of disclosure standards being negotiated bilaterally between contracting parties is unsatisfactory, and can lead to abuse. As the industry has grown, and as it has attracted more retail investors and institutions, more commentators have expressed the need for greater transparency than exists today. In Chapter 6, we return to the issue of negotiated disclosure of risks and positions in our discussion of side letters. These

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[6] *Global Pensions*, October 2007, page 18.

[7] Mercer Investment Consulting, *"European Institutional Marketplace Overview 2006"* May 2006

[8] A closed-end fund is an investment company with a fixed capital that issues its own securities. These are often quoted on an exchange. They are normally subject to company law, and not therefore regulated as collective investment schemes.

are arrangements with some but not all investors, conferring greater disclosure and redemption rights in return for a larger investment, or for other reasons of interest to the hedge fund manager.

We are concerned that, where a hedge fund makes illiquid and risky investments, the advance knowledge and early redemption opportunities available to favoured investors are reminiscent of insider trading and could be unfair on smaller investors.

2.4 Does Lack of Transparency Lead to Higher Operational Risk?

One reason for seeking greater transparency, it is argued, is that it can reduce operational risk([9]). The argument goes that uninformed investors are less able to discipline managers if they stray away from the fund's stated investment policy, exceed its leverage limits, or excessively concentrate their portfolios' risks. As a result, lower levels of disclosure lead to lower levels of market discipline.

(It is noticeable that in spite of the industry's high growth rate, hedge funds appear to close much more frequently than onshore funds. In their study of over 1,600 FoHFs between 1995 and 2004, Naik, Fung et al (2007) found that on average each year over 4% of funds were liquidated, and over 2% ceased reporting their net asset value per share to the data vendors used in the study. These latter funds may not have stopped reporting to their investors, of course.)

Most of the liquidations observed by Naik, Fung and their co-authors probably reflect a combination of high leverage and investment misjudgements which in combination lead to poor performance. Many fund closures were probably voluntary. If a manager experiences poor performance, it may be difficult without excessive risk taking to earn future incentive fees, since these typically operate on a 'high water mark' system, whereby past losses (or underperformance relative to the hurdle rate) must first be recovered before an incentive fee becomes payable. In these circumstances, a manager may prefer to liquidate an underperforming fund and if possible launch a new fund, a practice that is expensive for investors and makes monitoring of average investor experience more difficult.

Some failures however - such as the failure of Amaranth in late 2006 - may reflect a departure from stated investment policy that was not widely monitored or understood by Amaranth's shareholders. If neither commercial nor regulatory pressure is brought to bear on hedge funds' disclosure practices, then it would seem reasonable to assume that operational risk is enhanced. Against this argument, Michel Prada, the head of France's Autorité des Marchés Financiers, has warned against preconceptions of hedge funds as risky, quoting a failure rate in the industry of only three funds per thousand per year([10]), but without giving a source for this statistic.

The view that limited disclosure of positions and risks leads to greater operational risk is intuitively appealing, but there is little corroborating hard evidence. The connection between greater transparency (meaning more informed investors) and lower operational risk in the industry is therefore worthy of greater and more rigorous attention from researchers.

[9] Operational risk is defined by the Basel Committee on Banking Supervision as the risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events. It excludes investment risk. (September 2001).

[10] Revue Mensuelle de l'Autorité des Marchés Financiers, No. 32, January 2007

In conclusion, pure market-based pressure for improved transparency may be long delayed if, as seems likely, available capacity in the industry continues to outstrip demand. The combination of elevated management fees, limited disclosure of risks and positions, and lowered liquidity could all be different symptoms of the same underlying imbalance between supply and demand for the product. For market-based solutions to the problem of poor transparency to work, policy makers should consider how the supply of hedge funds or hedge-fund-like products by onshore managers can be increased or promoted through de-regulation. The additional competition would increase the commercial pressure on managers to provide more transparent reporting. We discuss how this might be achieved below.

2.5 Arguments against Disclosure of Positions

Is the lack of reporting defensible for other reasons than lack of effective commercial or regulatory pressure to report more fully? Some observers assert that position reporting is not desirable. Short positions, which are a part of the typical hedge fund's strategy, differ intrinsically from long positions, and are more open to damaging counter-strategies by competitors. Brunnermeier and Pedersen (2004) argue in their paper "Predatory Trading" that greater disclosure increases the incidence of destabilising trading by competing investors. Such traders can cause or worsen the distress of another investor by buying ahead of a counterparty known to be a forced buyer or selling ahead of a known forced seller. They speculate that LTCM found itself subject to predatory trading in 1998. In the trading model developed in that paper, greater disclosure leads to greater financial market instability risks, because predatory trading destabilizes by pushing market prices further away from equilibrium.

Many regulators appear to agree. In the words of Danièle Nouy, Secretary General of the French Banking Commission, "*Full transparency is neither realistic nor welcome when it impacts negatively market efficiency*."([11]) In the same publication, Callum McCarthy, Chairman of the UK's Financial Services Authority, was especially forthright on the subject of position reporting. "*The FSA is strongly opposed to a general requirement for hedge funds (or other asset managers or proprietary traders) to disclose positions, either to regulators or to the general public.*" Finally, the US has adopted a similar 'hands-off' approach to position reporting. The following extract is from testimony given by Christopher Cox, the Chairman of the SEC. "*"There should be no interference with the investment strategies or operations of hedge funds, including their use of derivatives trading, leverage, and short selling. Nor should the federal government trammel upon their creativity, their liquidity, or their flexibility. The costs of any regulation should be kept firmly in mind. Similarly, there should be no portfolio disclosure provisions.*"([12])

Disclosure of short positions may also hamper the beneficial effects of shareholder activism in disciplining company management. Short positions are treated with anger and suspicion by company management, who may try to bring pressure to bear on the manager or his fund's +unit holders. Excessive transparency would reduce the manager's flexibility; longer term it could reduce financial innovation. Proprietary methods employed by hedge funds could be copied by others if transparency were imposed.

[11] "*La Supervision indirecte des hedge funds*". Also see Axel Weber, President of the Deutsche Bundesbank "*Hedge funds : un point de vue de banque centrale*" both reports in "*Banque de France • Revue de la stabilité financière – Numéro spécial hedge funds • N° 10 • Avril 2007*. The full report can be downloaded from http://www.banque-france.fr/gb/publications/telnomot/rsf/2007/rsf_0407.pdf

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

There may be other reasons for not pursuing the avenue of greater position transparency. Lo (2001) gives an example in his paper on risk management of hedge funds of a simple strategy of shorting out-of-the-money S&P500 index options. The results of such a simple strategy were in his hypothetical example very profitable – if sufficiently leveraged - for eight years, but the hypothetical fund also became insolvent in a single month when the S&P turned down sharply. Lo's argument is that the positions themselves could be constructed in a number of ways, and indeed could disguise the true risk exposures.

As for the attitude of the hedge fund managers, anecdotal evidence points to a wide variety of attitudes on position transparency. Reflecting the diversity of hedge fund strategies, some managers would have little difficulty with greater transparency; others fear the threat of reverse engineering of their strategies, and insist that it would question their whole business model.

2.6 Managed Account Platforms

To meet the demands for greater transparency from larger institutions, prime brokers and others have introduced in recent years a new product known as the managed account. According to one source, managed accounts represented in April 2007 10% of assets under the management of hedge fund managers([13]). It is described by the Alternative Investment Management Association (AIMA) in the following terms.

"A Managed Account (MAC) is an investment vehicle that will be set up to mirror closely the trading activity of a Hedge Fund. A MAC will normally be structured by the investor and his lawyers and usually takes the form of a corporate entity. The aim of a MAC is to provide the investor with exposure to the manager's strategy without investing directly in the Hedge Fund."([14])

The MAC is therefore not unlike the business model of a typical defined benefit pension fund, whereby a global custodian holds securities on behalf of a principal, but an investment manager is appointed as the client's agent to execute trades, subject to the terms of an investment management agreement.

While the motivation behind this innovation may be to overcome some undesirable features such as the adverse tax treatment of the direct fund or FoHF approach, this product also addresses a number of the transparency issues raised above. It remains to be seen whether it can be extended to smaller institutions or even into the retail part of the industry. One limitation of this approach is that only a subset of hedge fund managers would 'self-select' to offer this greater transparency. Some may argue that there may be some 'adverse selection' issues in the sense that only less skilled managers who are not able to gather assets through traditional channels would elect to subject themselves to full transparency and monitoring.

Nevertheless, MAC is an example of how commercial pressures are bringing about change which goes in the direction of the demands made by the industry's critics, but without the need for additional regulation.

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[13] http://ftalphaville.ft.com/blog/2007/04/02/3583/managed-accounts-scupper-hedge-funds-ipo-plans/

[14] "Guide to Sound Practices for European Hedge Fund Managers", May 2007

2.7 Other Transparency Issues

We have concentrated in this chapter on transparency to investors of positions and risks assumed. Elsewhere we comment on issues of transparency of commercial arrangements to all investors. Another question is whether there is sufficient transparency to other counterparties such as prime brokers or lenders.

The difficulty of extending direct supervision by regulators to offshore entities has encouraged a number of regulators to focus instead on their onshore intermediaries, and in particular on their prime brokers. A prime broker will provide or arrange finance for hedge funds, execute and clear trades, and provide position and other portfolio reporting to the manager and to the administrator. Accordingly, prime brokers are in theory well-placed to monitor their own and their client exposures, and operate satisfactory prudential risk controls.

Concern over the effectiveness of these arrangements arises however from two sources. Firstly, the more secretive hedge funds may appoint several prime brokers, making it more difficult for any one prime broker to exercise commercial discipline through margining requirements, for example. Secondly, prime brokerage has been a lucrative business for the main providers, and there is worry that in order to increase their market share, firms may compete by relaxing their risk management standards. Thus prime brokers may themselves be conflicted, and this could compromise their ability to act as an agent of indirect supervision of hedge funds, as some regulators suggest.

2.8 Earlier Guidance on Risk Disclosure

For some years, transparency has been an issue for institutional investors with existing or planned hedge fund investments. As early as January 2000, the International Association of Financial Engineers (IAFE) launched the Investor Risk Committee specifically to consider this question. After six meetings, the Committee reported in July 2001([15]) The report attempts to summarize and define the type of reporting that would meet the needs of a sophisticated investor seeking transparency from his investment manager.

Institutional investors have a particular need for information from investment managers in order to facilitate the monitoring of risk exposures in their own portfolios. The Committee considered these needs and reported back that hedge funds' disclosures should be evaluated on four dimensions:

1: Content

a. Asset class and geographic exposures
b. Correlations with appropriate benchmarks
c. Value at risk statistics
d. Delta, Vega and other Greek statistics of any optionality
e. Key spread relationships
f. Stress tests on the fund's net asset value and simulations of investment strategies to explore the range of likely outcomes

2: Granularity, which appears to be an alternative word for the level of detail. For example, a detailed risk report would contain information of particular 'factor' exposures such as to small or illiquid companies.

[15] The full report can be downloaded from http://iafe.org/upload/IRCConsensusDocumentJuly272001.pdf

3: Frequency – how often is the information delivered? A minimum of quarterly was acceptable to the Committee, but more frequently for high-turnover strategies, and finally

4: Delay – how soon after the end of each period was the information available.

The Problem of Aggregation

The risk reporting desiderata identified above some years ago have been repeated in more recent guidance and codes of best practices, and would provide valuable - though still limited - input to the decision making of an expert investor, such as a FoHF manager, or a large institutional investor or its investment consultant, capable of choosing single hedge fund managers directly. However, even these expert buyers are likely to find it difficult to aggregate such information into their total portfolio risk measures. Consider for example a risk reporting item such as "correlation with appropriate benchmarks" listed above; many hedge funds will insist that their funds have absolute return targets with benchmarks such as cash or short term deposit returns such as Libor. Thus although the levels of volatility can themselves be meaningful, it may not be meaningful to try to combine them into a picture of portfolio risk, because it is unclear from the individual reports what the covariances of one hedge fund with other funds are.

The recommended disclosures listed above may also be relatively infrequent - quarterly for example - and describe the portfolio at a point in time. They are known as "holdings-based" risk measures because the portfolio risks they describe are determined by the hedge fund's holdings (or positions) at a point in time. To gain insights into how one fund's returns correlate with another's would require a 'returns-based' analysis. This uses the time-series of returns; returns-based analysis operates without knowledge of holdings or other point-in-time measures, but is useful because patterns of correlation between managers, or between a manager and the wider portfolio and between managers and benchmark indices can be studied. However, because managers can change their trading strategy frequently, quarterly data may not provide meaningful risk figures. By the time any statistical significance could be achieved, the manager's strategy is likely to have evolved. Even with monthly data, typically two years' returns would be needed, and in that time, the single hedge funds' strategies may have changed considerably.

Nevertheless, a consistently applied and widely adopted voluntary code of best practice would represent a major improvement, and from this brief discussion, the essential elements of a system that allows private sector disciplining of hedge fund managers begins to emerge. These elements would consist of comprehensive and standardized information covering quantitative and qualitative risk reporting, and both holdings-based and returns-based measures on each fund. In addition of course, one also needs sufficient expertise among investors that they are collectively able to exploit the information provided. Retail investors are less likely to be in a position to exploit such data, but we do not anticipate retail investors using single hedge funds. Instead investor protection would be improved via better monitoring by FoHF managers or other professional investors such as the larger institutions.

2.9 More Recent Guidance on Best Practice and Codes of Conduct

We are aware of the following voluntary codes of conduct and sources of guidance for hedge funds and hedge fund investors. These are in addition to the IAFE Investor Risk Committee referred to above.

- **AIMA - Alternative Investment Management Association**[16]

AIMA is an industry body representing hedge fund and FoHF managers outside North America. It publishes several 'best practice' guidance texts, including "The AIMA Guide to Sound Practice for Hedge Fund Managers" available from the website.

- **MFA - The Managed Futures Association**[17]

This is the North American equivalent of AIMA. Again extended guidance exists (a 150 page manual) covering issues such as reporting to shareholders and counterparties, valuation methods and operational management, but the organisation does not appear to cover in detail the reporting of risk exposures to investors.

- **CFA Institute**

The CFA Institute([18]) Centre for Financial Market Integrity promotes fair and open markets and is an advocate for investor protection and high professional standards. Its Code of Conduct for Asset Managers includes a Chapter on disclosure which is included as Annex 3([19]). More specifically, the Centre has drawn up an official position with specific regard to the transparency needs of hedge fund investors([20]).

The CFA Institute Centre, which acts as the advocacy arm of the CFA Institute, is apparently unique among interest groups, lobbyists and regulators in recommending full *position* transparency as well as the disclosure of risk measures by hedge funds.

- **Hedge Fund Working Group (HFWG)**

The HFWG is the initiative of fourteen large London-based hedge fund managers. It assembled in the summer of 2007 to codify best practice for hedge funds([21]) According to the Financial Times newspaper the Group's consultation document has been welcomed by a number of those who have been most critical of hedge fund practice in the past ([22]).

This code of best practice recommends that in the offering document and audited annual reports, the managers disclose the realized volatility, Value at Risk measures, leverage (high, low, and average for the period), measures of portfolio liquidity, and the investment instruments used.

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[16] www.aima.org

[17] www.mfainfo.org

[18] The Chartered Financial Analyst Institute is a global association for investment professionals, with approximately 90,000 voting members and 135 societies worldwide.

[19] Available at http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n4.4008

[20] http://www.cfainstitute.org/centre/positions/im/hedgefunds_transparency.html

[21] See www.hfwg.co.uk for the full document, the timetable of the consultation exercise.

[22] . Hans Mirow for example, Germany's deputy Finance Minister, was quoted as saying "Our initial impression is that the draft is in line with our own recommendations." Financial Times, 12th October 2007

In the author's view, the code remains relatively undemanding. It recommends disclosure of details covering a fund's risk appetite in the audited annual reports for example, in addition to the prospectus, but the annual report is likely to be available only months after the fund's fiscal year end. Such reporting is unlikely to give material help to investors seeking to maintain a clear understanding of risks they have taken on if for example the investment strategy changes.

We would prefer to see greater transparency of risk measures made available to investors on a regular basis, leading to a market-based disciplining of managers. Instead, the code appears to rely more heavily on the senior management of the hedge fund manager and on the fund's board of directors. The first of these, internal management, would be appropriate only where the size of the firm allows for a sufficient segregation of duties. The second – the board of directors of the fund – is in any case under the patronage of the hedge fund manager, and is therefore more likely to be compromised.

We believe that greater transparency would be achieved if the proposed code of conduct also required managers to report risk measures in regular newsletters to shareholder, or in updates to factsheets, using criteria for evaluation of such disclosures laid out in 2001 by the IAFE's Investor risk Committee – in brief, content, granularity, frequency, and delay.

Annual reports are simply too delayed and too infrequent to be of any help in a risk transparency role. We also believe that wide adoption of the (strengthened) code will need regulatory incentives to encourage compliance, and propose elsewhere in this report what those incentives could be.

2.10 Recommendations

In considering our recommendations on transparency, we have borne in mind the distinct needs of three groups:

- Investors, who need disclosures in order to make sound judgments about the investments they are making
- Regulators, who need assurance that investor protection needs are met, particularly for non-qualifying investors
- Investment managers, who need clear, simple, and consistent Europe-wide regulation

The challenge facing the industry and its regulators is as follows. On the one hand simply imposing additional regulatory barriers without significant simplification would be futile. Deregulation and standardisation of regulations across Europe is highly desirable, but is likely to be a slow, long-term project. On the other hand any voluntary code of practice must meet two criteria of effectiveness; it must be widely adopted and it must also be rigorous. However, these criteria work in opposite directions; the more the proposed code meets the needs of investors and regulators, the more the industry will ignore it or avoid full compliance. More specifically, the conflicting needs, of the industry for privacy, and of investors for disclosure have given rise to some pessimism regarding the ability of the European hedge fund industry to increase its scale, efficiency and availability to a wider client base.

Contrary to this pessimism, we believe that major improvements for all concerned are within reach, but that they depend upon reasonable compromise by both the industry and its (many) regulators. In brief, a combination of a strict, demanding, but still voluntary code of conduct combined with changes in the treatment of hedge funds by regulators would benefit all three groups. Without incentives to comply and without independent verification of compliance, we do not believe that significant benefits will flow from the efforts to articulate a voluntary code; and the code could well be ignored and abandoned within a relatively short timeframe. We address first the code of conduct, and then the regulatory issue.

- **A STRENGTHENED VOLUNTARY CODE OF CONDUCT**

A voluntary code needs a sponsor, and the question is which group or groups can and should write the code, monitor adherence to it, and impose sanctions for breaches. Clearly regulators cannot write voluntary codes, although they can encourage them. The code must emerge from the service providers or from those who use their services. In practice, only one group has come forward at the moment with a proposed code, and it makes sense to begin with an analysis of that effort.

In our opinion, as already stated, the proposed code of best practice is inadequate with regard to risk transparency. They fail to build on the IAFE criteria of content, granularity, frequency, and delay described in their 2001 report. **Our recommendation is that the Group reviews its proposals in the area of risk transparency and disclosure and requires for compliance monthly or at a minimum quarterly reporting of these items to investors.** These updates would contain a minimum set of standardized quantitative measures and there would be also a requirement to disclose material qualitative risks. Indeed, the disclosure requirements could build upon existing international accounting standards, particularly IFRS 7.

Furthermore the current proposals depend excessively in our opinion on internal reporting to those involved in a fund's governance, i.e. the fund's independent directors. This is especially true with regard to valuation practice. While important, we believe this group suffers from the 'patronage' problem. Its members are typically appointed by the manager. Our alternative recommendation, to provide investors with more regular and more complete information facilitates a market-based discipline, where the self-interest of investors works to provide investor protection. We do not accept that the envisaged risk disclosures would threaten in any way the hedge fund business model, since our criticism relates principally to the frequency and delay of disclosure, not its content or granularity.

In terms of disclosure the code of best practice focuses on disclosure of the nature of intended risk-taking at a fund's outset. The principal disclosure recommendations appear to be in the fund's prospectus. We are inclined to criticize this approach, on the grounds that many hedge funds are opportunistic, and will change their focus and strategy often. One of the major characteristics of hedge funds is that they are unconstrained. Reliance on a vague and out-of-date prospectus is in our opinion inappropriate. Emphasis is required instead on frequent and prompt disclosure to investors, through regular newsletters for example, not in prospectuses or annual reports.

We also have serious criticism of the proposed code's treatment of side letters, but these are discussed in a later chapter.

Our second recommendation is that compliance with the code should be subject to an annual audit by the fund's auditors, and that the auditors be independent and be required to state their opinion on the fund's compliance in the annual report to shareholders.([23]) At the moment, the proposed code of best practice contemplates either a third party approach, or an in-house annual review. We have no confidence that an in-house approach is likely to engender respect among investors or regulators. We can understand why the investment management firms would prefer an in-house solution, but this solution would undermine the code's effectiveness, and could lead to it being ignored.

- **CHANGES TO REGULATIONS**

Regulators can provide the industry with strong incentives to adopt a strengthened and audited transparency code. To do so, we propose the following:

1: Firstly, EU regulators and policy makers should review the distinctions they make between individual hedge funds and FoHFs. A properly diversified FoHF, with a competent and well-informed manager, is a relatively low risk investment product compared to many mainstream products, and in particular to equity funds. The existing restrictions on FoHFs in the EU are against the long term interests of consumers insofar as they apply to all FoHFs, that meet the legitimate informational and diversification criteria for adequate investor protection.

2: In this report, we do not define in detail the terms 'properly diversified' or 'well-informed'. Instead we would borrow for the first term on the concepts of diversification used by UCITS III (such as the 5/10/40 rule). The diversification rules on FoFHs could also be designed to incorporate a minimum number of different investment strategies within each FoHF.
For the second term (well-informed) we would restrict such FoHFs to invest only in funds – whether offshore or not – that comply with the strengthened code described briefly above, thereby incentivizing these funds to adopt greater transparency, without compelling them to divulge sensitive information about their positions.

3: **Our proposal is that regulators within the EU introduce a category of FoHF that is onshore and regulated**. To encourage this, we recommend that CESR revisit the look-through provisions of UCITS III. Portfolio diversification rules that ensure good diversification can be defined by regulators so that the risk characteristics of these regulated FoHF are quite ***dissimilar*** to the risk characteristics of the underlying, component funds. The 'look-though' provisions may have a role in combating other abuses, but they appear counter-productive and inappropriate in this situation.

4: If policymakers decide that a change to UCITS III is not feasible, **a second-best solution is to encourage national regulators - particularly in the larger countries - a) to align their FoHF regulations, and b) to consider the cross-border marketing of non-harmonized product, i.e. to enter into reciprocal recognition of each other's accreditation of products.** These bi-lateral arrangements could lead to significant savings – of benefit to consumers – particularly if adopted by a core of larger countries. The simple act of standardisation of definitions and limits by a small number of regulators in the larger countries could bring about significant benefits to consumers and service providers.

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[23] There are precedents for the use of auditors to strengthen voluntary codes. The Global Investment Performance Standards (GIPS) regime operated by the CFA Institute is similar.

We consider that these proposals create incentives that would over time significantly enlarge the supply of product, thus correcting the apparent supply / demand imbalance we see today. This would contribute to not only a larger industry, but also a healthier industry and would do so efficiently, by harnessing private sector disciplinary forces and by enabling benefits of greater economies of scale to be passed on to the end investor. In closing we would add that a number of regulators and fund managers are content with the status quo. However, our proposals do not compel managers to comply with the voluntary code we describe, and if they wished to continue with existing arrangements, they would be free to do so. Their funds would then not be permitted as holdings within an onshore FoHF.

3. RETAILISATION

3.1 Current Regulatory Practices

Within the European Union, the market for investment funds operates today as a well-understood, level playing field only at the extremes of the 'sophistication' spectrum. By this we mean that at the most sophisticated end, qualified investors – high net worth clients – can invest in hedge funds by way of private placements, but they do so without national or EU investor protection measures to support them. At the other end of the spectrum, lies the UCITS III fund that can be offered cross-border to retail clients without investment expertise or experience.

In the middle there is a market for non-harmonized funds. It is through non-harmonized investment products that most investors gain access to hedge funds, and it is here that regulation across the EU is fragmented and confusing. National regulators have adopted different frameworks. Some differences are small; others are more material, but each difference raises the cost of providing investment services across the EU.

In Annex 5, we map out schematically this situation. On the left of the chart are the relatively clear situations of a UCITS investment and a private placement, although even here different definitions of a private placement exist. In the middle are the non-harmonized funds, and on the right hand side are a variety of other means by which EU citizens either buy or are sold investment products with greater or lesser exposure to hedge funds.

The right-hand side of our schematic diagram in Annex 5 shows in addition structured products, quoted closed-end vehicles, and managed accounts as additional channels by which retail investors can and do obtain access to hedge funds. The next two Annexes, Annexes 6 and 7, taken from the European Commission's Report by the Expert Group on Alternative Investments, illustrate the regulatory differences in more detail. Annex 6 addresses retail access, and Annex 7 addresses life assurance and pension fund restrictions on hedge fund investing.

It is difficult to believe that this regulatory climate provides equal and fair access to all EU citizens, is conducive to investor protection, facilitates the disciplining of the hedge fund industry by expert buyers, or enhances the investment industry's scale efficiencies and product innovation capabilities. In order to make sense of how the regulatory scene affects questions of hedge fund retailisation, we should keep separate three broad categories of regulatory frameworks. These are:

1. **Regulations governing the *products* that are permitted or prohibited**

UCITS III, for example governs products, as do national regulations for non-harmonized funds or listing rules governing quoted companies. For our purposes we can divide the world of products six ways, as follows:

a) UCITS III Funds

b) Non-harmonized traditional funds

c) Funds of Hedge Funds

d) Single hedge funds

e) Individual securities

f) Derivatives

2. **Regulations governing the *intermediaries* who manage or advise on investment products.**

a) Discretionary portfolio management

b) Non-discretionary portfolio management

c) Advisory services on individual securities: The advisor recommends individual securities but has no responsibility for the suitability of each security or for the whole portfolio

d) Execution-only services: The retail client manages his or her own portfolio, and simply uses a financial intermediary to execute trades.

Within the EU, MiFiD is the most important legislation affecting managers and advisors.

3. **Regulations governing both the investment product and the intermediary**

a) Pension funds

b) Life assurance products

c) Structured products – often sold with a capital guarantee

Retailisation is a challenge to providers and regulators alike, precisely because it touches on so much of existing regulation.

3.2 Anomalies in Current Regulatory Practice

It appears that there are many anomalies in the current situation.
Looking at the product list above, we can ask what is permitted and what is not, and how this relates to the investor's risk of loss. Let us assume that the prohibitions are intended to reflect our actual experience of risk or loss. There have been no instances of a FoHF failing in Europe, and yet, they are widely prohibited. Very many traditional funds suffered major losses in the bear market of 2000 to 2002, yet they are widely permitted. Thus, FoHFs are ***perceived*** as high risk, but there is no evidence that they are. Of course we recognise that the absence of adverse outcomes is not proof that something is not risky – an investment can be risky even if no adverse outcomes have yet occurred – but we suggest that this is not the case here. In fact, to the contrary, Annex 8 contains evidence that relative to a typical equity fund, FoHFs have much lower risk of loss.

a) Another anomaly arises from the quoted closed-end fund industry. A number of these are available on the London Stock Exchange, and elsewhere in Europe. Anybody is permitted to buy them. Therefore an open-ended FoHF is not (yet) permitted, yet a closed-end fund doing essentially the same job ***is*** permitted. This is somewhat perplexing because the closed-end fund has the additional risk of discounts widening or narrowing, reflecting supply and demand for the quoted company's shares, leading to greater total volatility than its open-ended counterpart.

b) The third anomaly is that while FoHFs are often prohibited, financial institutions widely advertise much riskier investment products. Spread-betting on the stock market and contracts-for-differences services on individual shares are routinely offered to a wide and inexperienced public, with impunity, while a FoHF with the volatility of a long government bond is restricted. In some countries, no distinction is made between individual hedge funds and diversified funds of hedge funds; they are treated alike and in at least one country are subject to the very high minimum threshold for qualified investor status of €500,000.

c) The fourth anomaly is portrayed in Table 2. Once something is prohibited for an individual investor, it remains prohibited irrespective of the level of expertise brought to bear on the management of his or her portfolio. Neither the professionalism of the manager, nor the quality of the local regulator's supervision of the manager will open the doors to hedge fund investing. Yet becoming a qualified investor does open these doors.

d) Finally, UCITS III provides an automatic passport for distribution throughout the EU, yet it is being interpreted in different ways by different countries. For example Ireland has recently announced that it will permit managers to establish short positions in individual securities, not synthetically by means of derivatives, as in other countries, but by means of short positions in the physical security.

e) UCITS III is also the governing legislation, because of the cross-border marketing possibilities that it confers, for a large number of absolute return funds. These are now attracting tens of billions of dollars of retail investment within the EU. On closer inspection, many appear to resemble individual hedge funds, with return targets of up to 5% above money market rates. Their advertised sources of excess return read like a multi-strategy hedge fund, while their advertised anticipated risk levels appear to exceed those of FoHFs.

3.3 Retailisation via Structured Notes

Let us turn now to our third group of regulations, those that pertain to both the product and its distribution channel. According to Terras et al, "*the phrase 'hedge fund structured products' encompasses any form of indirect or 'notional' investment the returns on which are referenced to the returns generated by hedge fund strategies.*"([24]) These instruments – often in the form of a five year maturity investment bond or note issued by a bank or insurance company are a form of de facto retailisation of hedge funds. They are thought to be growing rapidly. According to the Report of the Alternative Investment Expert Group([25]), structured products were already capturing between a fifth and a quarter of hedge fund net flows in early 2006. In Europe, the majority of sales are to the mass and 'mass affluent' market.

In the article referred to above, Terras and his co-authors explain the motivation behind the issuance of structured products as follows: "*Structured products can also overcome regulatory barriers or investment charter restrictions which prevent an investor investing directly in unauthorised collective investment schemes, which hedge funds typically are. The structuring of retail launches, in particular, is often significantly influenced by a desire to achieve eligibility for inclusion within commonly used tax-efficient wrappers such as SIPPs, ISAs*([26]) *or offshore wrapper bonds.*"

Because of complex tax considerations, some structured products are also sold with some degree of attached life assurance. However, because they are typically distributed by insurance companies and retail banks sometimes via a direct sales force, and sometimes via intermediaries such as independent financial advisors, they are also covered by the MiFiD regulations.

[24] "Hedge Fund Structured Products" by Terras, Yonge, McGuire and Laurenson, Hedge Fund Journal, June 2006

[25] European Commission, Internal Markets and Services DG, July 2006

[26] SIPPs and ISAs are UK retail investment terms for Self Invested Personal Pension and Individual Savings Accounts respectively.

Clearly, the regulatory barriers that seek to prevent retail access to hedge funds and FoHFs are not completely effective, and major financial service companies are playing a role in their avoidance. However, the process of bringing hedge funds to retail in a circuitous manner adds a number of layers of fees and costs, which are ultimately borne by the retail investor. It is important that the investor is fully aware of the costs he or she is incurring. In other words, the principle of transparency should also apply to the costs paid by investors. This can be achieved through regulation which requires full disclosure of fees and costs paid by investors in order to earn a net return of, say, 1%, 5%, 10% and 15%.

3.4 Retail Exposure via Pension Funds and Insurance Companies

We referred in Chapter 2 to the growing interest in hedge funds among European pension funds. In our opinion, the increasing role of institutions as a source of business for hedge funds is to be welcomed. Unlike individual investors, institutions have the expertise and the buying power to enforce higher standards of governance and greater transparency on the hedge fund industry. Pension funds as purchasers of hedge fund product are part of this institutionalisation process. Annex 7 shows some examples however of how national pension fund and insurance regulations hinder the use of hedge funds by these savings institutions.

Another anomaly is therefore the following: that apart from the inconsistencies from country to country the very institutions that could bring discipline to the hedge fund marketplace in Europe, to the benefit of all, are prevented from doing so by capital adequacy requirements and other regulations that hamper their involvement and yet appear to bear no relation to the amount of investment risk incurred.

For example, some observers believe that even recent proposals at the European level remain grounded in irrational fears and misconceptions. During early 2007 the Committee of European Insurance and Occupational Pensions Services (CEIOPS) has worked on capital adequacy requirements for European pensions and insurance businesses. According to a report by EDHEC – see Annex 8 for details of the source – FoHFs will be subject to a considerably higher capital charge than would apply to their equity holdings. As the table in Annex 8 shows however, FoHFs have an observed level of volatility which is a minor fraction of that arising from a broad equity index such as the S&P 500. The EDHEC report, which is itself evidence-based, draws attention to the potentially flawed argumentation that appears to underpin the current proposals.

Table 1 - PRODUCTS, PERMISSIONS AND THE RISK OF LOSS

Vehicle	Generally Permitted for retail Clients?	From Investment Risk
UCITS III Fund	**YES**	**MODERATE** (Equity funds have substantial investment risk)
Non-harmonized traditional Funds	**YES**	**As above**
FoHF	**VARIES**	**LOW**
Single Strategy Hedge Funds	**NO**	**MODERATE**
Individual Securities	**YES**	**VERY HIGH**
Derivatives	**YES**	**VERY HIGH**

Table 2 - EXPERT MANAGEMENT MAKES NO DIFFERENCE TO WHAT IS PERMITTED

Vehicle	Generally Permitted for retail Clients?	MANAGEMENT ARRANGEMENTS			
		EXECUTION ONLY	ADVISORY	PORTFOLIO ADVISORY	DISCRETIONARY MANAGEMENT
CITS III Fund	**YES**	**PERMISSIONS DO *NOT* VARY WITH LEVEL OF EXPERTISE AND PROFESSIONALISM BROUGHT TO THE MANAGEMENT PROCESS**			
Non-harmonized traditional Funds	**YES**				
FoHFs	**VARIES**				
Single Strategy Hedge Funds	**NO**				
Individual Securities	**YES**				
Derivatives	**YES**				

Both tables compiled by the authors, October 2007

3.5 Conclusions on Retailisation

We note with interest that the Council of Europe has requested a report from the Commission on asset management. The accompanying press release is attached as Annex 2. The report is to be delivered by mid 2008. It will focus, at the specific request of Peer Steinbrück, Germany's Finance Minister, on a Single Market framework for the retail-oriented non-harmonised fund industry. Steinbrück specifically mentions in this regard the possibility of including FoHFs within this framework. This is a significant opportunity; hedge funds products developed under one national framework with a well-considered retailisation structure – could be made available cross-border, bringing greater competition for the consumer and greater opportunity for cost efficiency for the providers.

We understand fully that single strategy hedge funds can legitimately be characterized as having high investment and operational levels of risk, and are not appropriate for unregulated distribution to retail investors. In this and the previous chapter on Transparency, however, we have attempted to show that while well-intentioned, the current regulations at both EU and national level are at times ineffective and often anomalous. The regulations are widely circumvented, as we saw in the growth of structured notes and absolute return funds. In creating these products, the intermediaries are incurring a much greater cost, which is ultimately borne by the investors in terms of a reduction in the return on investment.

We recommend that efforts be made to make costs more transparent to the investors. Each product should be required to specify clearly to investors the gross percentage returns needed, before all fees and identifiable third party costs borne by the investor, in order to earn a net return of, say, 1%, 5%, 10% and 15%. For investors in FoHFs, the 'rate-of-return deduction' should be a composite of the FoHF's own fees and fees on the underlying funds, which of course may require a certain number of assumptions, which will need to be included in the disclosures. We acknowledge that the existence of high-water-mark provisions present a particular challenge.

Finally, the disclosures should also alert investors to the additional frictional costs, such as spreads and commissions, that are not accurately quantifiable, which arise from the fund's trading activities.

Turning to the regulatory environment in which hedge funds and FoHFs operate, it is unclear whether existing regulations do meet the investor protection needs of the investor, yet clearly they do prevent or hinder the emergence of private-sector based disciplining forces on hedge funds. In particular, the regulations fail to distinguish between single strategy offshore funds and FoHFs that include them in their portfolios. In other words they do not recognize the diversification effects of FoHFs, and the protection from both investment and operational risk that these and other well-resourced intermediaries such as pension funds and insurance companies can bring.

We argue that these intermediaries should be encouraged, by the removal of existing impediments, to bring about the investor protection framework that existing regulation is attempting to achieve. **We recommend that national authorities give further consideration to the proposals regarding mutual recognition of investment product authorization put forward in the Report of the Alternative Investment Group, July 2006**. The proposed arrangements could be bi-lateral or multi-lateral, and would make possible an effective quasi-single market as envisaged under the UCITS Directive, but without having to wait for changes to the Directive. The urgency of these proposals is only increased by the invitation extended by the Council in July 2006 for the Commission to review the arguments for and against changes to the retail-oriented non-harmonized regulations.

4. SHAREHOLDER ACTIVISM AND OTHER TRANSPARENCY ISSUES

4.1 Other Transparency Issues

In Chapter 2 we examined the concept of transparency in terms of the periodic disclosure by hedge funds of portfolio risks and positions held. Transparency also relates however to three other potential disclosures, namely:

- Who owns the shares issued by hedge funds?
- Who owns the investment management company that manages the hedge fund?
- Do hedge funds give rise to specific concerns about the disclosure of changes in beneficial interests in market-traded securities that do not arise in the case of other investors?

Because of the rise of shareholder activism, our main focus in this Chapter will be on the third – namely the timely and full disclosure of interests in target companies. We precede that discussion with some brief remarks on the first two transparency issues listed above.

4.2 Beneficial Interests in Hedge Funds

Only in a minority of cases will individual investors in the fund appear on the shareholder register in their own name. Often the shareholders will be corporate entities, but a typical situation is that in which different layers of financial intermediation occur between the beneficial owner of the fund's shares([27]) and the fund itself. Typical intermediaries may be funds of hedge funds that issue their own shares/quotas and in turn invest in hedge funds, but also banks and other custodians acting as a nominee for the end investor. Therefore, even for the administrator (or fund manager) of a hedge fund, who has access to the Fund's shareholder register, it is virtually impossible to know the identity of all of the final beneficial owners of an investment fund.

The UK has legislation under the Companies Act 2006 enabling company management to 'drill down', i.e. to force disclosure of beneficial ownership behind nominee names, but it is unclear how far these powers can be enforced in other jurisdictions. Also it appears that these powers are not available to non-UK companies. This is an area where further cross-border strengthening and harmonisation of laws could prove helpful to company management.

However, knowledge of the identity of the end beneficiaries is irrelevant for the way the fund is managed by the investment manager, as typically investors in the fund have no direct way to influence its management – they typically have no voting rights nor do they have full real time visibility of the fund's investment strategies. The only way investors in a hedge fund can influence the management of the fund is by redeeming or threatening to redeem their shares/quotas if they are dissatisfied with the investment policy.

On the other hand, current anti-money-laundering procedures, strictly enforced by hedge fund administrators, ensure that the trail leading to all the end beneficial owners can always be uncovered by the authorities (courts, police, and securities markets regulators) in case of need.

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[27] Although we use the word "share" here, the concept of course extends to "units" in a fund, and is intended to mean broadly a beneficial interest in, or a right to a beneficial interest in, a fund.

It is true, though, that some trails may take a considerable time to be reconstructed if particularly secretive jurisdictions are involved, and if the reason for the enquiry has not to do with recognized serious issues. However, this problem is not at all specific to hedge funds. Any transaction –whether in securities or not – involving countries with banking secrecy laws will present the same issue.

We do not recommend that transparency be extended to beneficial interests in hedge funds. Our reasoning is that other parties, for example company managers, may be tempted to exercise inappropriate, biased, and self-interested influence on these owners, should they find themselves in conflict with an activist strategy pursued by a hedge fund.

4.3 Ownership of the Management Company

This question is of importance in that it is the staff of the investment management company who take decisions in respect of the fund's investment. Clearly if, because of the ownership structure, a hedge fund management company is prone to serve systematically specific interests, e.g. those of a larger industrial/financial group, then the logic of the investment strategy may be biased. However also here it is hard to highlight an issue that is specific to hedge funds. On the contrary, the hedge fund industry is extremely fragmented, with the vast majority of management companies owned by individual entrepreneurs.

Management companies being fully regulated in Europe, the regulator both knows the identity of the end beneficial owners of the management companies and enforces "fit and proper" requirements on all the individuals involved with the ownership and management of such a company. Thus, a potential concern may be those management companies that are not regulated within EC jurisdiction and/or that are not regulated at all. However, this falls beyond the EU jurisdiction.

4.4 Shareholder Activism and the Transparency of Interests in a Target Company's Securities

4.4.1 Definition of Activism

Shareholder activism is defined as "*encouraging alteration in behaviour by companies that could be beneficial to their shareholders"*.[28] An extended definition may be that adopted by the OECD, which defines it as "*seeking to increase the market value of their pooled capital through active engagement with individual public companies. This engagement may include demands for changes in management, the composition of the board, dividend policies, company strategy, company capital structure and acquisition/disposal plans, which are normally regarded as corporate governance issues."*[29]

Neither of the bodies quoted here see anything intrinsically good or bad about activism, but it is a controversial topic, and we should remember throughout any discussion that:

- Not all activist funds are hedge funds: most activism is undertaken by long-only investment managers, by private equity firms, and by commercial firms as acquirers of other firms. Traditional managers may exercise their activism differently from hedge funds, often behind closed doors, and in a less transparent manner.
- Not all hedge funds are activist: in fact less than one fund in one hundred publicly adopts this strategy, and even the funds that do espouse it will also hold positions where no intervention in corporate strategy is envisaged.

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[28] Hedge Fund Working Group Consultation Document, Part 2, Page 52.

[29] OECD, *"The Implications of Alternative Investment Vehicles for Corporate Governance: A Synthesis of Research"*, July 2007.

4.4.2 The Opportunities Created by Lax Corporate Governance

Hedge funds attract special attention for their role as activists for several reasons. Firstly, they often run concentrated portfolios; this enables them to focus on specific situations in turn. There is no diversification requirement on them, and they can and do use leverage to increase their economic power. In all these respects they differ from traditional funds.

Secondly activist hedge funds are not so frequently embedded within larger organisations such as banks or insurance companies, whose wider interests may conflict with their duties as shareholders. In this respect, hedge funds are ***less*** conflicted than traditional funds. Thirdly, hedge fund managers operate under greater incentive arrangements, implying that they are more likely to become activist or join others in an activist strategy, if they judge the likelihood of a profit to be sufficient.

Fourthly, the opportunities for activism are likely to be higher where other investment managers fulfil their shareholder ownership duties less diligently. This may be because they adopt an explicitly passive, indexed approach, or because they are conflicted by being part of a larger group such as a bank with lending or other business with the target, or simply because they prefer to keep a low public profile for public relations reasons. Many believe that this lax corporate governance model creates a vacuum that allows incumbent corporate managers considerably more freedom than is appropriate, and that that freedom is often exploited to their personal benefit, and at the expense of shareholders' interests.

If this view of lax corporate governance by traditional owners is correct, then clearly there will be companies who pursue strategies that are purely in management or some other stakeholder's interests, and this provides the raw material for activist hedge fund intervention. Those who favour shareholder activism believe that it brings substantial economic benefits long term, in focusing management on the task of using scarce capital and other resources more efficiently. (Those who oppose shareholder activism often do so from a philosophical base than can loosely be defined as managerial capitalism([30]).)

Thus for the reasons given, hedge funds are more likely to be involved in shareholder activism, but much hedge fund activism operates in exactly the same way that a private equity or other firm would operate, and subject to the same public disclosure requirements when shareholding positions are acquired or disposed of. These are governed today within the European Union by the *Transparency Directive*. Disclosure is normally required at 3% and at one per cent intervals thereafter.

There may however be scope for extending and harmonizing current law in two respects: firstly, there may be variation in the requirements for prompt notification of changes; and secondly, countries may vary in the extent to which they demand the aggregation of shareholder interests with any voting rights that can be obtained by the exercise of options held by the same party. It is the wider, more inclusive definition of 'interest' in a company that is needed for full transparency, particularly since company managements have reported instances of bullying or threatening behaviour by investors claiming to control six, seven, or eight per cent of a company via derivative holdings, before any record of such interests becomes visible on the company register.

[30] Chandler, A D, "The Emergence of Managerial Capitalism", Business History Review, 1984

4.4.3 The Separation of Economic and Ownership Rights

Apart from the use of leverage and the absence of diversification requirements, hedge funds are characterized by their use of stock borrowing – normally but not always to establish a short position - and of course by their use of derivatives. Both these techniques may also be used in a hedge fund's activist strategies, and some observers consider both techniques may be used inappropriately to reduce the transparency of their activism.

Common to both stock borrowing and derivatives are the separation of economic and voting interests. Annex 9 illustrates various transaction types and their impact on voting and economic interest. We should note however that the separation of economic and voting power is a very old practice.

It has been practiced by European companies for many years, and typically involved the concentration of voting power in particular classes of shares, to the exclusion of other classes, and in various forms of shareholder disenfranchisement. Indeed the European Commission has only recently abandoned its attempt to tie voting and economic power together with the attempt to impose "one-share, one-vote" rules. It is ironic indeed therefore that just as this policy was being abandoned, there was much interest in the practice of "empty voting" by hedge funds.

Empty voting is defined as the retention of voting powers while no longer having an economic interest. A hedge fund could for example borrow stock to vote, while simultaneously shorting the same or a greater amount of stock in the derivatives market. Alternatively the hedge fund could vote the stock and then return it before the outcome is known to the public. In either case, a voter could be economically favoured by an outcome that harms the economic interests of shareholders in general. For a discussion of these practices see Hu and Black, 2007([31]). Hu recounts the 2006 story of the Hong Kong company, Henderson Land, which offered a premium to the then current share price for the minority stake it did not own in its subsidiary Henderson Investments. To its surprise the offer was turned down on a vote. Allegedly, a number of hedge funds had purchased shares or borrowed stock to vote, while simultaneously shorting the company's shares in the derivatives market in greater numbers than they held in their long, voting positions. When the vote failed, the share price dropped by 20% to its pre-bid price, and the hedge funds profited on their net short positions.

Although this is not thought to happen frequently, it is of sufficient concern to have aroused the attention of both European and North American regulators. The possible remedies are three-fold: firstly, policy makers could encourage free market solutions, in part by reducing regulatory impediments; secondly by relying on voluntary codes of conduct; thirdly by introducing new regulations. Taking each in turn:

- **Market-based Solutions.** The brief description of the Henderson Land situation above may have been addressable under European market abuse legislations. However, in general, hedge funds' empty voting should not be condemned too hastily, particularly since commercial companies are so fond of the practice. The stock lender, a necessary player in the process, receives a fee for the loss of voting rights, and that fee is negotiable. The vote has itself an economic value, and the fee for transferring the vote should reflect the risks of losing control. Did the institutions who lent their stock to the hedge funds believe that their stock lending fee was a 'free lunch'?

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[31] Hu, Henry T.C. and Black, Bernard, "*Hedge funds, insiders, and the decoupling of economic and voting ownership: Empty voting and hidden (morphable) ownership*" Journal of Corporate Finance, Vol 13, June 2007

In other words, the stock lenders are operating in an open market, and know, or should know, of contentious forthcoming resolutions that are subject to shareholder vote. Yet securities lending is today an opaque, unlisted private market. Interestingly, before 1929 short position prices used to be quoted on the main stock market in United States.

We recommend therefore that policymakers examine the operation of the stock lending market in Europe. Is the level of transparency correct? Is there a lack of competition in the market for global custody services that underpins the stock lending market? Does the US have greater competition and transparency regarding the extent of lending, and fee rates, than exists in Europe, and if so, why, and what remedies can be considered?

- The second solution – if indeed there is a genuine problem – would be to rely on voluntary codes of conduct. Here, the HFWG has drafted best practice proposals as follows: *"Hedge funds following best practice will not engage in practices such as voting on borrowed stock while not being economically exposed."* ([32])

  In general, in its discussion of the issue, the position of the HFWG appears to be that a stock borrower should act in the lender's interest because the lender retains an economic interest in the company. We cannot agree that this is the correct analysis. It appears to conjoin the purely economic value of a shareholding with the value of control, i.e. the value of being able to vote. These are not identical. **We recommend instead that voluntary codes focus instead on full transparency and the disclosures required to achieve this.**

- The third solution is more regulation. However, regulation in this area could not, or should not, address simply hedge funds; it must be general in scope and address the targeted activity, not specific vehicles. The proposed voluntary code of best practice supports this extension of regulation in these words. *"Therefore, the HFWG recommends that regulators take action to introduce a regime (similar to that of the Takeover Panel in the United Kingdom applicable during takeover offer periods) requiring notification of "economic" interests in shares held via instruments such as CFDs."*([33])

  We believe that a case can be made for all notifications of large shareholdings under the Transparency Directive to include a) significant (3% or greater) short positions, and b) also any derivative positions, whether long or short.

In considering extensions of regulation in order to improve transparency, it is clear that one should first consider existing EU legislation. In the area of transparency of ownership, it is clear that one should start with the Market Abuse Directive, and ask in what particular respect it may be deficient. There are two possible areas in the Directive:

- Manipulating transactions: Dealing to give false or misleading impressions as to supply, demand or price, or trading at abnormal levels (MAD Offence)
- Dissemination: Engaging in dissemination of information to give false or misleading impressions (MAD Offence)

[32] Hedge Fund Working Group Consultation Document Part 2, October 2007, page 48.
[33] Same, page 47

We recommend that regulation proposals be fully cognisant of

a) the long-established and widely tolerated instances of empty voting by companies, i.e. consistency with the one-share, one-vote issue,

b) the alternative possibility of promoting free market based solutions, bolstered perhaps by compulsory voting by traditional investment managers, and

c) by promoting increased awareness among them of the true value of their voting rights.

Finally, consider also that in acquisition proposals, investment banks and their acquirer clients may have been themselves manipulating share prices in order to ensure a successful – for them – outcome, and are themselves conflicted. Most importantly, traditional long-only investment managers who neglect to vote need again to consider whether they are failing in their shareholder responsibilities. **We urge policymakers to consider whether institutions should be forced to vote on all resolutions put forward at annual and extraordinary shareholder meetings.**

4.4.4 Joint Action / Acting in Concert by Hedge Funds

Finally, the transparency of hedge fund behaviour has also been questioned in respect of their acting in concert. Acting in concert is itself not illegal, but if voting strategies and other actions are jointly planned, then the parties become a concert party and become subject to the same notification of interests regulations as if they were one party. They also become subject to the same takeover laws, and could be forced to offer to purchase all outstanding shares at the highest price paid by any one member of the party. Hedge funds are accused from time to time of acting as an undeclared concert party, or more pejoratively, as a "wolf pack".

The OECD Synthesis of Research on Corporate Governance (op cit) covers this topic at Chapter 3.5 of its report, while the HFWG provides clear proposals for the guidance to those responsible for the governance of hedge funds. Some national governments are however sufficiently concerned about the risk of undeclared concert parties to consider the outlawing of any coordination between shareholders. In other words, rather than undeclared concert parties being illegal, all concert parties would be illegal. This suggestion has been met with dismay by the International Corporate Governance Network. **We believe that acting in concert should be disclosed and should be subject to the same disclosure laws as an individual party, but that extensions to cover all consultation between shareholders would be detrimental to the welfare interests of parties with the exception only of incumbent managers.**

5. INSIDER DEALING

5.1 Definition

Insider dealing refers to the practice of illegal trading on the basis of material non-public information, or the dissemination of such information to others. It is prohibited at the European level as part of the Market Abuse Directive. Two of the five offences listed in the Directive are relevant – insider dealing itself and improper disclosure of information.

Insider trading is an unusual crime, in that indirect evidence suggests it may be widespread, and yet prosecutions are extremely rare. The indirect evidence is in the form of suspicious market movements in share or other security prices ahead of price-sensitive announcements, for example takeover offers. The simple idea is that without insider dealing there would be only limited abnormal price behaviour prior to the official disclosure of material price-sensitive information. If there is abnormal price behaviour, then at the very least, insider dealing is suspected. Of course, some price movement may occur before an announcement where the acquirer is building an initial small stake, beneath the 3% trigger at which the bidder must declare a stake. Studies by academics and regulators suggest that between one quarter and one half of all takeover announcements are preceded by abnormal price appreciation. The contrast is therefore between a small number of legal cases on the one hand, and on the other hand literally hundreds of 'abnormal' share price movements preceding price sensitive announcements over the space of a few years.

5.2 Hedge Fund Involvement

While there is no direct connection between hedge funds and insider trading, there are widely held suspicions that hedge funds are disproportionately involved in insider trading, a) because they are perceived as secretive, b) because they are heavy users of derivative markets, especially over-the-counter derivatives where monitoring of trading by authorities is more difficult, c) because their incentive arrangements will encourage such behaviour; and finally d) because they in any case account for a significant proportion of trading on securities markets.

Stalmann et al (2007) report for example that hedge funds account for between 25% and 50% of all trading on major exchanges, while Feenstra et al (2007) reported hedge funds to be the majority counterparty in structured credit trades. In the US traded options markets, Scheer (2007) reports a doubling of option volume on average in the three days preceding a takeover announcement. Furthermore as important generators of commissions, stock brokers are said to have released price sensitive information on planned third party trades in exchange for a greater share of the future commission flow from hedge funds. However, these academic and other studies merely point to circumstantial evidence of insider trading by hedge funds.

5.3 Hedge Funds as Providers of Capital in Primary Securities Markets

Hedge funds are often active in the primary market for capital, and it is in this function that some evidence arises. Involvement in the primary market inevitably involves them as insiders, as deals are being planned. For example the convertible arbitrage strategy prospered during the bear market of 2000 to 2003 as companies – especially technology oriented companies – were unable to fund expansion by the issuance of new equity. Hedge funds stepped in as suppliers of risk capital when others withdrew, and were praised for doing so. It appears however that there were cases of hedge funds using the knowledge gained as funds providers, and therefore as insiders, to trade in existing securities in the secondary market ahead of price-sensitive news.

Thus hedge funds might short a company's shares immediately prior to an announcement of a major convertible bond offering, in which they were an underwriting participant. The case of Philippe Jabre of GLG Partners is now in the public domain.

In brief, Philippe Jabre was 'brought over the (Chinese) wall' (i.e. made an insider) by Goldman Sachs International in February 2003 as part of the pre-marketing of a new issue of convertible preference shares in Sumitomo Mitsui Financial Group Inc (SMFG). Jabre was given confidential information and agreed to be restricted from trading in SMFG shares until after the issue was announced. Jabre breached this restriction by short selling around $16 million of SMFG ordinary shares between 12th and 14th February. When the new issue was announced on 17 February 2003, Mr Jabre made a substantial profit for the GLG Market Neutral Fund. He and GLG were each fined £750,000 for this offence by the FSA. According to Bloomberg Jabre traded on privileged information more than once. He sold shares of the French company Alcatel SA in 2002 after Deutsche Bank AG alerted him to an Alcatel convertible bond sale. Although the French regulator, the AMF, did not fine Jabre as an individual, they fined GLG Partners €1.2 million for this transgression. ([34])

Hedge funds are also active in the debt markets. In their working paper "Insider Trading in Credit Derivatives", Acharya and Johnson (2005) study the syndicated loan market, writing *"hedge funds are reported to commonly purchase small syndicate stakes precisely to acquire non-public information to aid them in arbitrage trading."* Acharya and Johnson look at trading in the credit default swaps market and in the shares of the company when there is adverse credit news held by a syndicate of lenders. They are particularly interested in the cases where there is a large number of syndicate members, and which is therefore more likely to include hedge funds, as these are not typical 'core' members of a debt issuance or debt restructuring syndicate. In their conclusion they write, "*we provide empirical evidence that there is an information flow from the credit default swaps markets to equity markets and this flow is permanent and more significant for entities that have a greater number of bank relationships.*" This appears to support the notion that hedge funds may be deliberately entering debt restructuring syndicates in order to obtain insider information for use in equity markets.

Finally, the SEC investigated a number of so-called PIPE deals in 2006. PIPE is an acronym for Private Investment in Public Equity. A distressed company places a new issue of shares with hedge funds at a discount. The shares are then registered for re-sale, which is often dilutive for existing shareholders. The SEC has already fined several hedge fund managers who used their insider knowledge by shorting the company's shares before the dilutive announcement was made. These three examples – in convertible arbitrage, in credit derivatives and in PIPE transactions, all suggest that insider trading by hedge funds is a particular threat to market integrity when they act in the primary securities markets, as suppliers of risk capital.

5.4 Hedge Funds and Insider Trading: Recommendations

The hypothesis that hedge funds are likely to be involved in insider trading arises from their role as liquidity providers in complex securities and derivative contracts, their involvement in financial innovation, and their closeness to investment banking counterparties, which arises from their substantial trading volume. All of these factors point to their integration into the security and derivative markets that have exploded in volume since 2000. We know for example that trading in credit default swaps has multiplied many times in recent years.

34 Extracted from Wikipedia.

We also know that hedge funds contribute to market efficiency as arbitrageurs in markets where security returns are correlated with each other. As the volume of cross-border trading and trading in complex derivatives increases, regulators clearly find it more, not less, difficult to fulfil their supervisory role.

The over-the-counter (OTC) nature of this trading contributes to the market's opacity. But without data, the regulators are powerless. One solution is to borrow from the US the idea of a "trade warehouse" as initiated by the Depository Trust and Clearing Corporation (DTCC) and US industry bodies in 2006. Because of the close integration of different national markets, we believe that the data warehouse concept in Europe would make sense only at the supranational level. **We recommend therefore that EU policymakers investigate the feasibility of a project to establish a European data warehouse covering OTC derivative trades, on the DTCC model.**

5.4.1 Compliance Culture within Hedge Fund Management Companies

Another way in which we can assess the risk of insider trading is to investigate the internal compliance procedures for handling price sensitive information within hedge fund management firms. As London is the largest European centre for hedge fund managers, it makes sense for us to consider the UK regulator's assessment of these procedures.

In late October 2007, the FSA reported on visits to a cross section of hedge fund managers.([35]) It was clear from their report that the FSA found a great deal of complacency within firms. *"We were disappointed by some of what we saw"* is one citation from the report. The regulator repeatedly found that procedures to mitigate the risk of price-sensitive information being abused were inadequate, and in particular record-keeping – for example of meetings with company management – were below the standards the regulator sought.

What can be done to ensure improved compliance procedures within management firms? We presume that the FSA can and will sanction firms for inadequate controls, whether or not actual insider trading is suspected.

We also recommend that regulators and industry bodies work to ensure that the industry has an adequate training and continuing professional development programme, which incorporates within its workforce an improved understanding of regulatory compliance issues and ethical standards. This will require close cooperation between the regulators, voluntary bodies and examination-setting organisations such as the CAIA Association (the Chartered Alternative Investment Analyst Association) and the CFA Institute.

[35] FSA Market Watch Issue No. 24, available from http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter24.pdf

6. OTHER CONFLICTS OF INTEREST

Hedge funds are probably as prone to mishandling conflicts of interest or outright fraudulent behaviour as any other financial service business. The purpose of this Chapter, however, is to draw attention to those aspects of the hedge fund business model where conflicts arise that are specific to this industry. There are two major areas where a hedge fund manager is conflicted - one that we label side letters and the other in the area of portfolio valuation. We address each in turn and then discuss other potential conflicts of interest that have to date not been the focus of industry bodies or regulators.

6.1 Side Letters

In Chapter 2 we addressed a number of transparency matters, as they relate to hedge fund investing. We did not address there however the issue of side letters. These are arrangements between the hedge fund or its manager and some, but not all, investors. They may offer preferential non-transferable redemption rights to some investors, or key man terms allowing exits if a named individual leaves, or enhanced disclosures, preferential subscription rights or preferential investment management fees. The managers concerned are conflicted in the sense that a major subscription may be conditional on the negotiated terms - for example a 'wholesale' subscription from an institution or a fund of funds available on special terms and subject to negotiation. At the same time, a manager may not wish to disclose the existence of these side letters arrangements for fear of discouraging continued investment by existing, non-preferred investors.

The existence of undisclosed side letters is now seen as being unfair on investors in general. However, it may not be sensible or feasible simply to prohibit them. For example, a fund of funds business may find that it needs to negotiate side letters with managers for 'wholesale' fee rates simply to remain profitable, if they form part of industry practice. Competitive pressures would force them to participate in the practice, and attempts to prohibit them could simply drive the practice underground. Instead the European industry appears to be adopting a disclosure policy whereby the existence of material terms in side letters is made available to all investors. This guidance came into effect in the AIMA *Guidance Note* dated September 2006. This Note itself followed a number of meetings between the FSA (the relevance being that over 80% of European hedge fund management firms are regulated by the FSA) and AIMA during 2006. The FSA *Feedback Statement 06/2* made clear that the FSA believed that failure to disclose material terms contravened at least one of its principles, including the principle of fairness to clients([36]). We are not aware of contact between AIMA and other regulators on this matter. **If it has not taken place, then wider consultation is recommended.**

6.1.1 Differences in Materiality

Many observers recognize that not all side letters are equally important. Evidence by SEC staff to the US Congress indicates that the SEC distinguishes between material and non-material side letters. Those generally considered less harmful to other investors are the ability to make additional investments in otherwise closed funds, and fee reductions. However two other side letter practices are considered potentially more harmful, namely preferential access to portfolio information and preferential redemption rights.

The reason for regulators and industry bodies to take these issues more seriously is that hedge fund investors are expected to accept higher risk and lowered liquidity.

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[36] FSA Feedback Statement 06/2 "*Hedge funds: A discussion of risk and regulatory engagement*" March 2006

Transparency is therefore important. If one set of investors has more information about portfolio positions or portfolio characteristics, and at the same time can exit earlier, other investors can be disadvantaged.

A manager may be forced to sell more liquid holdings in order to meet a favoured client's redemption requests, such that the residual portfolio is difficult to realize. This can materially and adversely affect the remaining investors, and they should be informed of such risks.

Are "key man" side letters material? These are letters that commit a fund to inform an investor if a particular fund manager falls ill, or for any other reason ceases to manage the fund. This may look non-material, but again, it is easily imaginable that it places some investors in a preferred position to others, prompting perhaps an earlier redemption.

6.1.2 Disclosure Practices

Other side letter issues concern the manner of their disclosure. For example, do the contents of side letters need to be disclosed, or simply their existence? Who is responsible for side letters and their disclosure; is it the fund manager or the fund itself? Should parties to the letters be disclosed? Should the number of side letters issued be disclosed? Is a letter material if it is issued to holders of five per cent of the issued capital? To 10%? What about the date of issue? These are all matters that preoccupy investors, managers and regulators. Many of them remain unresolved.

Briefly, the AIMA Guidance limits itself to the *existence* of a side letter and the topic covered in it, but not the detail of its contents. Therefore its guidance is that disclosure is required to the effect that a letter exists on preferred redemption terms, but not the parties to the letter, the number of letters, or dates the letters were issued.

Regulators may also face difficulties about their competencies with regard to side letters. Some observers([37]) hold the view that the fund and not the manager is responsible for side letters, and if the fund is offshore, then it is not within the competence of the regulator to govern questions regarding their issuance. The HFWG also appears to consider that side letters are a matter for directors of a fund, not its manager. It states in its Consultation Document, *"The fund directors should be made aware of their personal responsibility for the issuance and legality of side letters or discretionary waivers"*([38]) This citation appears to indicate that the Group agrees with the view that side letter disclosure must be covered by a voluntary code of practice. However the Consultation Document is unclear on the role of a regulator in side letter disclosure.

In conclusion side letters have attracted the attention of regulators and voluntary groups within the industry, and yet many questions appear to remain unanswered, or have elicited only minimal requirements on the industry. **We recommend that policymakers move quickly to eliminate the uncertainties surrounding side letters, strengthen the reporting and disclosure requirements, either by statute or via voluntary codes, and monitor adherence to these revised requirements.** Such moves can only enhance the degree of confidence in hedge funds as an investment product, and therefore also form part of good business practice.

[37] *"Hedge Funds and side letters: where next? Where does the FSA stand?"* Kate Wormald, Hedge Fund Journal, Issue 24, February 2007

[38] HFWG, Consultation Document, Part 2, Page 41

6.2 Valuation Practices

Hedge funds frequently invest in 'hard-to-value' derivative contracts, or obscure, perhaps untraded, complex instruments, especially in the structured credit markets. In the absence of properly segregated duties within the management firm, managers could wrongly influence the valuation by administrators of these securities to their own benefit. For this reason, AIMA began work in 2003 on recommended valuation procedures, and a manual was produced in 2005. The manual was revised and re-issued in March 2007([39]). Similarly, the draft guidance from the HFWG draws attention to the issue of correct valuation procedures and the surveillance of these by an independent board of directors as part of their governance duties. The problem is particularly acute where the manager is small, and segregation of duties is impossible or difficult. In Europe, the universal practice of outsourcing administration and portfolio valuation for NAV calculations goes some way towards mitigating the problem.

The conflict of interest arises because of the economically significant incentive fees payable to managers. A manager effectively owns a call option, or a series of call options, on the net asset value per share, with a strike price equal to the NAV high water mark, exercisable at the end of December each year, where December is the fiscal year end of the fund. If the NAV is above the option strike price, the option is 'in the money' and has intrinsic value. Below it, the option expires worthless. Circumstances arise therefore where the manager is incentivised to place the highest possible valuation on securities or even to manipulate their price, in order to 'push' the NAV into territory that grants him or her an incentive fee for the year.

An academic paper by Agarwal, Daniel, and Naik (2007) *"Why is Santa so kind to hedge funds? The December return puzzle!"* is available for download from the London Business School website at www.london.edu/hedgefunds . The paper finds that hedge fund returns are significantly higher in December than in other months, and that a seasonal change in strategy, such as taking more risk at year end, does not explain the higher returns. Nor do markets on average have higher returns in December. The higher December returns appear to be at the expense of 'borrowing' from January or 'savings' from earlier months.

The opposite incentive also exists: managers with weak year-to-date returns or managers significantly below their high water marks are tempted to postpone returns that would not in any case trigger a performance fee payment into the following January, when there is a possibility they would count toward an incentive fee.

This conflict of interest is to be taken seriously therefore, since the path-dependent nature of the incentive fee 'option' means that, with manipulation, a higher fee can become payable to managers than would be justified by the long term performance. In other words the risk exists, given the high incentives, of manipulation of returns between time periods in such a way that a greater incentive fee becomes payable which, without the manipulation of position valuations, would not otherwise have been payable.

We recommend that regulators view manipulation of valuations as a form of market abuse, and treat it therefore under the terms of the Market Abuse Directive. Again, it undermines confidence in the integrity of the product, and indeed could be interpreted as a form of fraud. We agree with the HFWG Consultation Document that the internal governance of a fund, the independence, integrity, and competence of fund directors are all of paramount importance in this regard, and form the basis of the avoidance of abuse.

[39] "AIMA'S Guide to Sound Practices for Hedge Fund Valuation".

6.3 Conflicts of Interest in the Fair Allocation of Trades

In parallel to the issue raised by the Agarwal, Daniel, and Naik paper described above, there is the general question of trade allocation within firms managing several funds, when high incentives exist. Thus a hedge fund manager with several funds may be conflicted in his or her allocation of trades, where the firm knows that it will benefit from an incentive fee in some but not in other funds.

Similarly, the growth of hedge funds has encouraged traditional investment managers to offer hedge funds alongside traditional long-only funds. These are hybrid firms. In these cases investment opportunities may arise that the manager can allocate to a traditional fund on perhaps a fixed fee of 1% per annum but without an incentive arrangement, or to a hedge fund where the manager or his firm will share in 20% of the gains. The regulations will insist on fair allocation between clients, but clearly the manager in these cases can face a severe conflict of interest in reaching a "fair allocation" result. We know of no cases that have reached the public domain, but would be surprised if firms have not faced these issues internally. It is for regulators of these hybrid firms to assess the risk of unfair allocation in their regular inspections.

6.4 Conflicts of Interests among Service Providers

The hedge fund industry's value chain is of course populated by inter-related service providers, each of which may have their own conflicts of interest. For example, a fund of hedge funds may find itself influenced by the availability of side letters guaranteeing capacity or fee reductions to include within their portfolios hedge funds that would not otherwise be included. Intermediaries such as fund of funds providers may therefore provide portfolio advice to a client that is biased by their own remuneration prospects, as happens in the onshore industry where financial advisers receive rebates and commissions from investment managers; many do not operate a fee-only service for clients but are conflicted by remuneration received from product suppliers.

Transparency and segregation of duties are also especially important where a large financial services firm performs several functions, such as manager, prime broker, and distributor. There is the risk of information leakage from a prime broker unit to a fund of funds unit; a prime broker or other service provider could misuse information gained in the prime broker function to gain advantage over competitors in its funds of funds operation.

In similar vein, banks may both act as lenders to hedge funds, and be actively trading in the same markets - credit default swaps markets for example - as their hedge fund clients, and are therefore incentivised to exploit their knowledge of others' trading to put themselves in a favoured position with respect to their own trading.

6.5 Conflicts of Interest: a Conclusion

We have explored in this Chapter a number of known potential conflicts of interest in the hedge fund industry. The hedge fund industry is not unique however in facing them, nor in the need to develop codes of practice and surveillance mechanisms that can provide assurance and comfort for end clients. However, a number of factors will contribute to a sense of heightened concern among regulators, clients and others. We would count among them the general lack of familiarity with how the industry functions, its tendency towards secrecy, its high degree of complexity and innovation, its rapid growth, and not least, its significant incentive fee arrangements.

In combination these factors place a responsibility on all stakeholders to pursue with care the identification and articulation of these challenges, and in particular the identification of those industry practices that need to change, and the careful consideration of how that change is most effectively to be brought about. We have made a number of specific recommendations to this effect.

7. SUMMARY OF RECOMMENDATIONS

7.1 Transparency

i) Our principal recommendation is that the industry adopt a strengthened voluntary code of conduct, building on proposals already put forward by the Hedge Fund Working Group. We list in our report where we believe those proposals are deficient.

ii) For that code to be taken seriously by investors, regulators and the public at large, we believe that adherence to it should be subject to independent verification, for example by the hedge fund's auditors, and that the audits of such fund be required to state their opinion as to the fund's compliance in the fund's annual report.

iii) Thirdly we argue that any such code would be ignored by large parts of the hedge fund industry if it is not recognized by regulators and if there is not some regulatory incentive for the industry to adopt it, in the form of the relaxation of existing barriers to market access for those complying. We argue that only in this way can the objectives of investor protection within the European Union be achieved without expensive and inefficient extensions to existing regulations.

None of these proposals has great utility in bringing about investor protection if taken in isolation; only if taken together, as a package, can they have their desired effect.

iv) Specifically we urge that the HFWG review its proposals in the area of risk transparency and the disclosure of key portfolio characteristics. We believe that any new code should require monthly or at a minimum quarterly reporting of these items to investors

By contrast we do not recommend that the proposed code should include position reporting. We consider that hedge funds are justified in seeking to keep their positions confidential.

v) EU regulators and policy makers should review the distinctions they make between individual hedge funds and FoHFs.

vi) The diversification rules on FoFHs could also be designed to incorporate a minimum number of different investment strategies within each FoHF

(1) We would restrict such FoHFs to invest only in funds – whether offshore or not – that comply with the strengthened voluntary code proposed above, thereby incentivising these funds to adopt greater transparency, without compelling them to divulge sensitive information about their positions**.**

(2) We recommend that CESR revisit the look-through provisions of UCITS III, enabling onshore FoHFs to invest in offshore single strategy funds

vii) National regulators – particularly in the larger countries – should seek to align their FoFH regulations.

7.2 Retailisation

i) National regulators should consider the cross-border marketing of non-harmonised product with a view to entering into reciprocal recognition of each other's accreditation of products. This is in line with the proposals of the Alternative Investments Group of Experts, which reported to the EU Commission July 2006

7.3 Shareholder Activism

i) We recommend full transparency of both economic and voting interests, and the disclosures required to achieve this.

ii) We recommend that all notifications of large shareholdings under the Transparency Directive should include a) significant (3% or greater) short positions, and b) also any derivative positions, whether long or short.

7.4 Insider Dealing

i) We recommend that EU policymakers investigate the feasibility of a project to establish a European data warehouse covering OTC derivative trades, on the DTCC model. This would deter insider dealing and assist in the investigation of possible insider dealing cases.

ii) We also recommend that regulators and industry bodies work to ensure that the industry has an adequate training and continuing professional development programme, which encourages within its workforce an improved understanding of regulatory compliance issues and ethical standards.

7.5 Other Conflicts of Interest

i) We recommend that policymakers move quickly to eliminate the uncertainties surrounding side letters, strengthen the reporting and disclosure requirements, either by statute or via voluntary codes, and monitor adherence to these revised requirements.

ii) We recommend that regulators view manipulation of valuations as a form of market abuse, and treat it therefore under the terms of the Market Abuse Directive.

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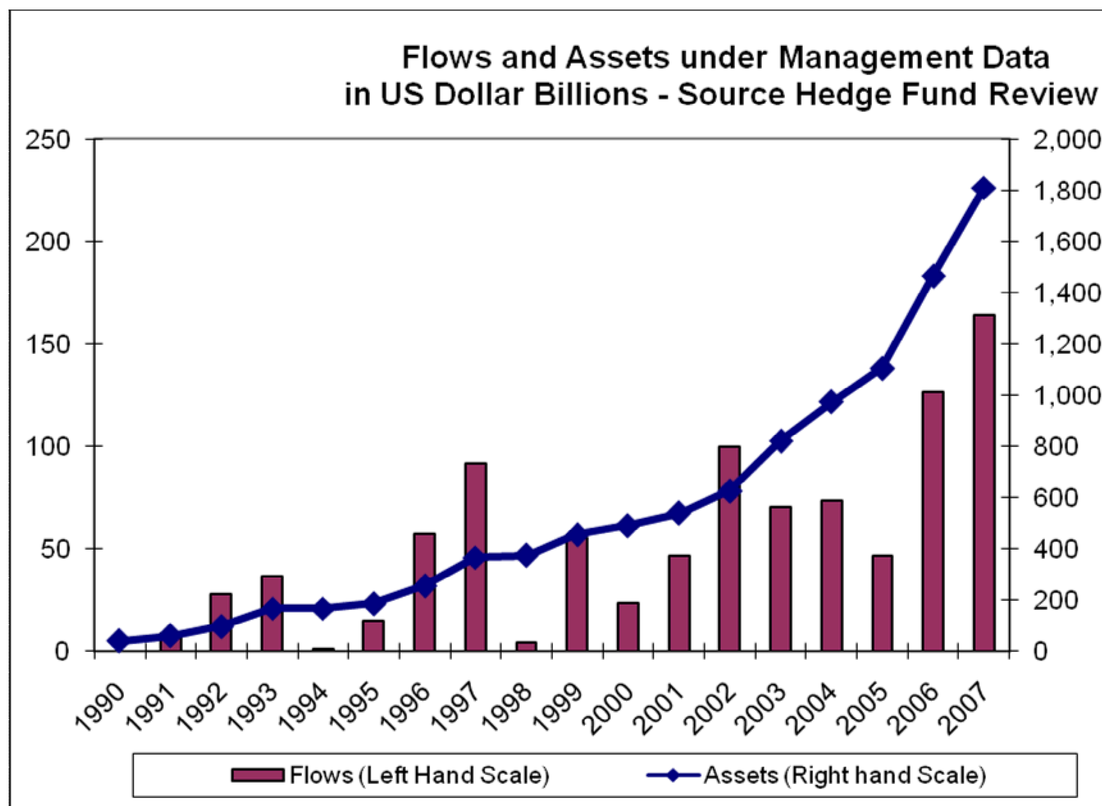
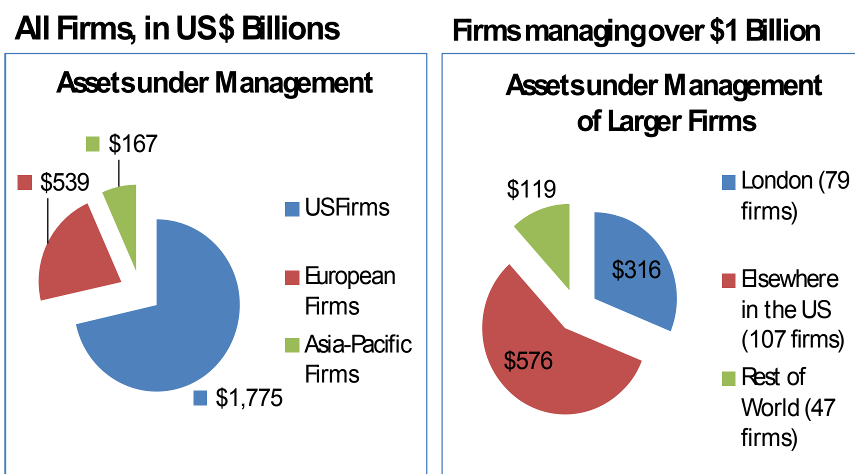
ANNEX 1: GROWTH AND DISTRIBUTION OF HEDGE FUND ASSETS



Source: "HFR Industry Report – Third Quarter 2007" at
http://www.hedgefundresearch.com/index.php?fuse=asset_flows&1196077660



Source: Report in www.hedgeweek.com dated October 2, 2007

ANNEX 2

HEDGE FUNDS AND FINANCIAL STABILITY: COUNCIL OF THE EUROPEAN UNION

Press Release Dated 8th May 2007

The Council adopted the following conclusions.

"The Council: –

EMPHASISES the importance it attaches to an integrated, dynamic and competitive financial marketplace in supporting growth and job creation through proper allocation of capital, including via hedge funds, and financial stability; –

ACKNOWLEDGES that hedge funds have contributed significantly to fostering the efficiency of the financial system, but also

STRESSES the potential systemic and operational risks associated with their activities,

NOTES that the so-called 'INDIRECT supervision' approach, through close supervisory monitoring of credit institutions' exposures to hedge funds and progress in upgrading their internal risk management systems, has so far enhanced resilience to systemic shocks; and

RECALLS the need for creditors, investors and authorities to remain vigilant and to adequately assess the potential risks that hedge funds present. In this context creditors and investors should also examine whether the current level of transparency of hedge funds' activities is appropriate. In the exercise of their 'indirect supervision', relevant supervisory authorities should monitor developments and cooperate among themselves; –

STRESSES the need for a better understanding of hedge funds characteristics for proper monitoring of the financial stability impact of hedge funds' activities, and therefore ENCOURAGES all relevant institutions to develop and apply an analytical and evidencebased approach in this area; –

NOTES that concerns have been expressed regarding increased retail distribution of hedge fund products in some Member States and RECOGNISES the need to ensure adequate investor protection; –

INVITES therefore the Commission to take all relevant regulatory and market developments into account, in assessing the case for and against providing a Single Market framework for the retail-oriented non-harmonised fund industry, which might include some funds of hedge funds; and LOOKS FORWARD to the Commission's report thereon."

ANNEX 3

EXTRACT ON DISCLOSURE IN
THE CFA CODE OF CONDUCT FOR ASSET MANAGERS

MANAGERS MUST:
Communicate with clients on an ongoing and timely basis.

1. Ensure that disclosures are prominent, truthful, accurate, complete, and understandable and are presented in a format that communicates the information effectively.
2. Include any material facts when making disclosures or providing information to clients regarding themselves, their personnel, investments, or the investment process.

4 . Disclose the following:

- Conflicts of interests generated by any relationships with brokers or other entities, other client accounts, fee structures, or other matters.
- Regulatory or disciplinary action taken against the Manager or its personnel related to professional conduct.
- The investment process, including information regarding lock-up periods, strategies, risk factors, and use of derivatives and leverage.
- Management fees and other investment costs charged to investors, including what costs are included in the fees and the methodologies for determining fees and costs.
- The amount of any soft or bundled commissions, the goods and/or services received in return, and how those goods and/or services benefit the client.
- The performance of clients' investments on a regular and timely basis.
- Valuation methods used to make investment decisions and value client holdings.
- Shareholder voting policies.
- Trade allocation policies.
- Results of the review or audit of the fund or account.
- Significant personnel or organisational changes that have occurred at the Manager.

ANNEX 4

TERMS OF REFERENCE FOR EUROPEAN COMMISSION EXPERT WORKING GROUP

(i) Identify, describe and document the legal, organisational, regulatory, and administrative and other barriers hindering the efficient development of the Hedge Fund and Private Equity fund markets on a cross-border basis. This would include, but not be limited to, barriers encountered at various stages along the investment fund value chain:

• Product manufacture, registration and notification

• Fund distribution, offer and marketing, market access

• Fund management, administration and safekeeping

(ii) Reflect on how the value-chain for these activities is organised across the EU and whether there are features of national tax systems or regulation which stand in the way of developmentof a business model capable of raising capital/ managing or administering funds /reaching investors on a cross-border basis, and whether these features are motivated by legitimate concerns;

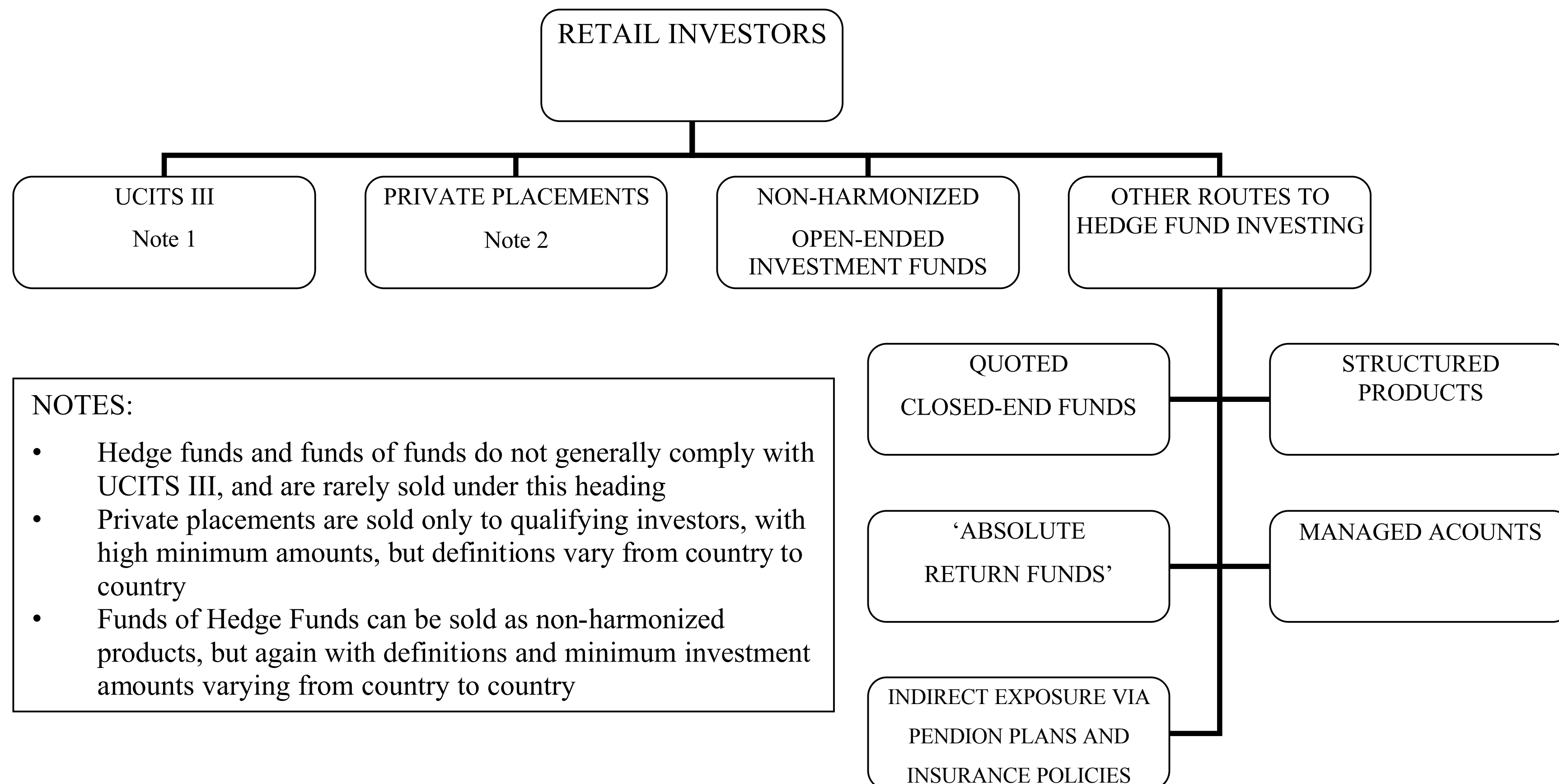
(iii) (as regards practical solutions to existing problems)

Propose solutions [where possible] that could be most helpful in overcoming the cross-border barriers identified by the Group. Test - in broad-brush terms - different options for overcoming those barriers against considerations of cost-effectiveness - also taking into account the possible impact on operators who are not active in cross-border markets. This latter work could include consideration of whether a common understanding of “private placement” could facilitate cross-border offers of non harmonised funds aimed only at professional investors.

The Group’s recommendations would aim to distinguish between: 1) optimal practical solutions to the removal of barriers to the Single Market; and 2) realistic solutions that are still worth pursuing even in cases where existing and foreseeable constraints in Member States cannot be removed in the short to medium term. In so far as any proposed solutions relate to identified trends and issues which may impact on the industry's customer base, the Group should give due consideration to any relevant investor protection concerns

ANNEX 5: ALTERNATIVE MEANS OF INVESTING IN HEDGE FUNDS WITHIN THE EU

Table compiled by the authors, October 2007



ANNEX 6

REPORT OF THE ALTERNATIVE INVESTMENT EXPERT GROUP TO THE EUROPEAN COMMISSION July 2006

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 ([40])
	OPCVM contractuels		€250,000
	OPCVM de fonds alternatifs (funds of hedge funds)	YES	€10,000([41])
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		€500,000
	Fund of hedge funds		
LUXEM-BOURG	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	

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

ANNEX 7: REPORT OF THE ALTERNATIVE INVESTMENT EXPERT GROUP TO THE EUROPEAN COMMISSION July 2006

INVESTOR RESTRICTIONS ON HEDGE FUND INVESTMENTS: VARYING TREATMENT IN EUROPE MEMBER STATES

COUNTRY	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.
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

ANNEX 8:

EDHEC REPORT ON THE QUANTIFIED RISK OF HEDGE FUNDS

Reference period: January 1997-December 2006	Maximum Drawdown (in %)	Volatility (in %)*	Downside Risk (in %)*	Modified Value-at-Risk (in %)**
S&P 500 Composite Total return	44.73%	15.35%	10.73%	7.12%
Convertible Arbitrage	8.22%	3.95%	3.19%	1.35%
CTA Global	11.68%	9.00%	5.04%	3.57%
Distressed Securities	11.62%	5.29%	5.30%	1.88%
Emerging Markets	35.45%	12.72%	11.51%	5.80%
Equity Market Neutral	1.07%	2.13%	1.16%	0.18%
Event Driven	10.92%	5.56%	5.88%	2.17%
Fixed income Arbitrage	12.61%	3.61%	6.26%	1.41%
Global Macro	5.36%	6.00%	2.48%	1.43%
Long/Short Equity	10.75%	7.08%	4.17%	2.36%
Merger Arbitrage	5.44%	3.71%	4.37%	1.34%
Relative Value	4.71%	3.31%	3.04%	1.00%
Short Selling	49.56%	20.21%	11.80%	7.96%
Funds of Funds	7.07%	5.72%	3.69%	1.71%

* *Annualised statistics are given*

** *Non-annualised 5%-quantiles are estimated*

Source: Report by Samuel Sender, Research Associate with the EDHEC Risk and Asset Management Research Centre, dated 23rd July 2007

ANNEX 9

TRANSACTIONS WITH DIFFERENTIAL VOTING AND ECONOMIC INTERESTS

TRANSACTION	ECONOMIC INTEREST	VOTING INTEREST
HOLDING STOCK	YES	YES
LENDING STOCK	YES	NONE
LONG POSITION VIA A CFD OR OPTION	YES	NONE But often can be exercised at short notice to obtain voting interest
BORROWING STOCK	NEITHER GAIN NOR LOSE	YES
BORROWING AND SELLING **(SHORT SELLING)**	SHORT INTEREST Benefit if stock price falls	NONE
SHORT POSITION VIA A CFD OR OPTION	SHORT INTEREST Benefit if stock price falls	NONE

Table compiled by the authors, October 2007

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The views expressed in this Report are those of the author and do not necessarily reflect the views of the London Business School. The author remains responsible for errors and oversights, if any.