

An E.U.-wide passport for hedge funds

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On 5 June 2003 the President of the European Parliament announced that the Committee on Economic and Monetary Affairs had been authorized to draw up an own-initiative report under Rule 163 on the future of hedge funds and derivatives. The committee considered the draft report at its meetings of 10 September, 4 November, 25 November, and 2 December 2003; and on 15 January 2004 the parliament passed the new proposals to introduce an E.U.-wide passport for hedge funds. This paper provides an overview of the discussions that were put forward in order to achieve such an approval.

What are hedge funds?

A W Jones established the first hedge fund in 1949 by combining two risky types of investment - short selling and leverage - in order to limit overall exposure to market risk. The fund was 'hedged' because he held both stocks, purchased with borrowed money, that would gain if the market went up, and short positions, that would benefit if the market went down. He also made the manager's fee a percentage of the profits (20% in his case) and committed his own investment capital to the fund.

The market has experienced dramatic growth since then. Today, assets under management are estimated to be between U.S.\$ 450 billion and U.S.\$ 600 billion and in 2001 there were 446 hedge funds managed in Europe, although this represented only 15% of the global total of hedge fund assets¹. During the same period, the variety and complexity of these investment pools has also experienced explosive growth, making it increasingly difficult to accurately define exactly what they are.

In 1999, the U.S. President's Working Group on Financial Markets defined a hedge fund as 'any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public'. But the U.K.'s Financial Services Authority has declined to define the term, on the grounds that there is no identifiable commonality.

Despite the difficulties involved in developing an all-encompassing description of a hedge fund, certain characteristics are common to all. These include:

- A legal structure in the form of private partnerships or investment corporations.
- Offshore location, usually in low tax and low regulatory regime havens.
- Performance related fees.
- Freedom to use a variety of investment techniques to enhance returns and/or to reduce risk.
- Limited to rich and sophisticated investors.
- A goal of absolute returns.

Hedge funds can also be loosely described according to their investment strategies. The primary investment categories identified by Tremont/TASS are:

Long/short equity - Investing on both the long and short side of the market so as not to be market neutral.

Convertible arbitrage - Taking a long position on a convertible security and a short position on its common stock.

Event driven - Profit from a corporate event (e.g. a merger).

Equity market neutral - Exploit inefficiencies in the equity market and minimise market risk.

Global macro - Profit from major economic trends or events.

Fixed income arbitrage - Profit from arbitrage opportunities in fixed interest securities.

Dedicated short bias - Invest mainly in short positions in equities and equity derivative products.

Emerging markets - Exploit inefficiencies and poor information in immature markets.

Managed futures - Trade in listed financial and commodity futures markets.

Funds of funds - Invest in multiple hedge funds with different investment styles.

We recommend that since the term 'hedge funds' covers such a wide range of financial products, it might be more appropriate to call them 'sophisticated alternative investment vehicles' (SAIVs).

¹ PricewaterhouseCoopers (May 2003).

Hedge funds in Europe

Until recently, hedge fund investors were usually 'qualified' individuals, who understood and accepted the inherent risks. In the last two to three years, however, there have been many new entrants, including small outfits run by former long-only asset managers. Pension funds and insurance companies are now becoming significant participants.

Since Switzerland, Luxembourg, Italy, Ireland, and Hong Kong eased regulations to make them more accessible to mainstream investors, funds-of-funds have also experienced dramatic growth in Europe. The German legislature is currently considering its own regulatory proposals. And although the U.K. recently decided not to relax its regulations³, Ireland has been perhaps the most active in broadening access to hedge funds. In December 2002 the central bank of Ireland allowed registered funds-of-funds to invest entirely in unregulated schemes, provided there is a minimum investment of €12,500, the fund manager has appropriate expertise, and the fund does not invest in other funds-of-funds. (Previously, retail investors could only access funds-of-funds that invested less than 10% of net assets in unregulated funds.) The UCITS directives permit funds-of-funds to invest up to 30% of their assets in 'other collective investment undertakings', including hedge funds, as long as they meet standards equivalent to the relevant directives³.

Despite all these developments, the current regulatory and fiscal conditions in the E.U. have discouraged the growth of an active hedge fund market within E.U. jurisdictions. Discriminatory taxes and regulations in some member states have held back potential investment in foreign domiciled hedge funds, including those in other member states. As a result, these vehicles are mostly domiciled offshore.

Success in attracting SAIVs onshore depends on establishing a lighter regulatory regime than for conventional UCITS. This regime should concentrate on provision of sufficient and intelligible information to the investor rather than on over-prescriptive rules and regulations. SAIVs could provide an appro-

appropriate regulatory home for other alternative investment funds, which do not necessarily pursue absolute returns, in areas such as property, currencies, or commodities, and which are beginning to enter the European market but are currently unable to take advantage of a single, E.U.-wide regime.

Growing interest from retail investors suggests that we should try and ensure that hedge funds are domiciled in Europe where they could be better supervised. After all, certain hedge funds may be directly accessible to retail investors anyway, without any specific protection, via European market listings or third country jurisdictions, or indirectly via funds-of-funds, which provide diversified entry to the sector, or structured notes.

As the Financial Services Action Plan nears completion, it is appropriate for the Commission to turn its attention to what would be a suitable legislative accommodation for hedge funds and other sophisticated alternative investment vehicles that currently lack a European regulatory home. In order to achieve this objective, the European parliament needed to consider and debate a number of issues.

The areas of debate

- The marketplace for hedge funds is fragmented due to varying regulatory regimes, a lack of consistent platforms, and discriminatory tax administrations. Institutional and private investors are showing increasing interest, but lack suitable vehicles in E.U. jurisdictions. We feel that a separate, lightly regulated regime would be the best option. Funds would elect to be regulated under this regime and would be required to adhere to its particular rules.
- There is concern about allowing hedge funds to be sold to retail investors without clear disclosure of trading strategies, performance fees, performance reporting, financial transparency, and certainty of pricing. It is clear that such products must have a very transparent and well-understood health warning as well as a fully comprehensible description of their style and risk profiles, including their fee structures.

² Financial Times, July 31, 2003, Thursday U.S. Edition 2.

³ In the U.S., concern about hedge funds has prompted a report by the staff of the Securities and Exchange Commission, which recommends more explicit means of regulation and registration of participants.

⁴ Directives 2001/107/EC and 2001/108/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC.

- There is concern about the systemic impact that hedge funds might have on financial markets via market, operational, and credit risk. Regulators and banking supervisors should develop means of assessing and exchanging information about the extent of any such accumulated systemic risks.
- Hedge funds can be high risk if there is inadequate internal risk control. Less habitual participants, such as corporates and individuals, may be less able to deal with them, and thus vulnerable to unforeseen and unsustainable losses. The accounting regulators should be implementing, in the context of internationally accepted accounting standards (e.g. the International Accounting Standards Board) and internal audit controls, a compulsory reporting system for all company accounts. For individuals, the only safeguard is recourse to education and some degree of protective regulation related to the extent of their knowledge, wealth, and sophistication.
- Regulators may have difficulty assessing risk and keeping up with fast-moving developments. They may not always be aware of the exposure of the international financial system as a whole. For the time being we would tend to favor co-ordination by national regulators rather than by an E.U. regulator. These will need to have staff with the expertise adequate to fulfill this rather exacting role in a fast-moving and technically shifting area of finance.
- Some argue that hedge funds contributed to recent market volatility; others say that they contribute to market stability. On balance, we feel that hedge funds contribute to the efficiency and self-balancing of financial markets and that a light regulatory regime in a free-flowing global market with near-harmonized basic rules would be the best option.

Based on the above, we made the following recommendations to the European Commission.

The committee:

- Reminds the Commission that Final Article 2 of Directive 2001/108/EC, requested preparation of a comprehensive report on this area of investment practice by 13 February

2005 and suggests, given the potential for systemic risk as well as the increased interest in the general investor community; that this should be brought much further forward.

- Given the fact that many hedge funds operate offshore and are not subject to E.U. regulation, calls on the European Commission to introduce legislation to make lending by E.U. financial institutions to offshore hedge funds more transparent; Feels it is opportune to facilitate access to SAIVs for the moderately affluent investor and, in due course, when the different regulatory authorities at European level recommend it is appropriate, the retail investor; and that regulated funds of hedge funds could play a vital role in this gradual process.
- Considers it timely to develop a light-handed and appropriate E.U.-wide regulatory regime for SAIVs that will help attract them to locate in the E.U. and provide the benefits of a common European passport by means of mutual recognition.
- Points out that a regulatory regime for SAIVs must be liberal enough not to negate their role as an alternative investment medium of choice or impede the freedom of investment managers (inter alia) to:
 - employ innovative and even exotic techniques and instruments.
 - take strong positions, including by the use of shorting, leverage, and derivatives.
 - be remunerated relative to their performance.
 Provided that their investment and operating methods are disclosed in appropriate terms to those who invest with them, directly or indirectly.
- Considers that the regulator must verify and be satisfied that the promoters, directors, and managers of a SAIV are fit and proper persons to be entrusted with responsibility for the savings and investment funds of third parties and are adequately expert and well-informed in the investment techniques and instruments employed in that undertaking; further that the risks inherent in any SAIV are clearly advertised and communicated to investors, that the advertised style of investment and level of risk are not exceeded, and that risk is properly monitored and controlled.

- Stresses that the SAIVs regime should concentrate most particularly on the distribution and sales methods employed, so as to avoid investment in them by persons for whom they are inappropriate.
- Considers that investment funds should be able to elect to be regulated under the UCITS or the SAIVs regime and be bound by that regime's requirements.
- Urges the investment industry and national regulators to sponsor campaigns to educate potential investors about SAIVs, their characteristics, and their risks.
- Considers it most desirable that distributors should be specifically authorized to distribute SAIVs and that such authorization should depend on their probity and level of knowledge regarding SAIV products and be renewable on a regular schedule.
- Considers it essential to provide individuals investing in SAIVs with a clear and simple risk description and warning to be acknowledged by them as representing their understanding of the risks involved.
- Encourages the industry to develop a self-regulatory code of conduct that encompasses aspects not expressly covered in the formal regime and in particular regarding appropriate sales and distribution methods.
- Accepts that a minimum limit might be imposed on investments into such funds while public understanding is poor but that this should be progressively reduced and ultimately eliminated as awareness improves.
- Suggests that it should be permitted for SAIVs, which have long-term investment horizons, to restrict the duration of windows for sales, redemptions, dealings, and net asset valuations.
- Considers that SAIVs should be required to run rigorous daily risk controls so as to ensure that they stay within their advertised risk parameters.
- Urges the industry, in consultation with the regulatory authorities, to develop easily understood and consistent risk measurements or indices, which should be published regularly to indicate to investors that advertised risk limits are being observed.
- Urges that an E.U. regulatory regime for SAIVs come within the Lamfalussy Process and that the detailed requirements be decided and regularly reviewed at level 2 but subject to Parliamentary scrutiny and call back.
- Calls on the Commission to consider whether a regime for SAIVs should be enacted as a distinct part of a revised UCITS directive or in a separate directive and considers that any such regime should cover hedge funds and other alternative investment funds.
- Considers that the world's supervisory authorities should develop an effective means, possibly including a centralized credit register at the Bank for International Settlements as proposed by the Financial Stability Forum of April 2000, to monitor and control the extent of credit, management, and operational risk that this sector could bring to the world's financial system and urges the Commission to instigate such a mechanism, which should also include the more effective enforcement of existing provisions.
- Calls on the Commission, in conjunction with national regulators, to investigate the practice (predominantly by American arbitrage hedge funds) to use time zone differences and the influence of Wall Street on other markets to profit by market timing Asian and European mutual funds, and to determine whether this significantly harms long-term investors in those funds and whether any steps need to be taken to rectify the situation.
- Expects the Commission to take action against member states that, by means of differential taxation, additional regulatory requirements or other methods, discriminate against SAIVs domiciled in other member states.
- Urges the Commission to consult with the legislative and regulatory authorities in the U.S., Japan, Switzerland, and other relevant jurisdictions with the aim of developing as consistent an approach as possible internationally in this area of investment, to report on implementation in the different member states and in third countries of the recommendations of the Financial Stability Forum, in particular in regards to hedge funds and the regulation of offshore centres, and to indicate what steps it intends to take with a view to the introduction of essential regulations at the international level.

Conclusion

This report on hedge funds (or SAIVs) was an initiative of the European Parliament. It obtained a very large majority of 344 to 69. The next step is likely to be for the European Commission to come forward with draft legislation in order to give effect to this initiative. With the imminent European Parliament elections (10 June) and the change of Commission (November), this may be delayed until early 2005. However, there is growing pressure from the investing public, from market practitioners who see a business opportunity, and from regulators. Furthermore certain E.U. countries (Ireland, Germany, and Luxembourg) are already bringing forward national regimes to permit the setting up of hedge funds.

I believe that the Parliament's resolution gives a viable blueprint for development of this business within E.U. jurisdictions. I hope it will be taken forward without undue delay.