



EUROPEAN CENTRAL BANK

OPINION OF THE EUROPEAN CENTRAL BANK

of 14 December 2004

**at the request of the Danish Financial Supervisory Authority on a proposal for a law amending the Act on investment associations and special-purpose associations and other collective investment undertakings etc. and the Financial Business Act
(Hedge funds)
(CON/2004/38)**

1. On 25 October 2004 the European Central Bank (ECB) received a request via Danmarks Nationalbank from the *Finanstilsynet* (Danish Financial Supervisory Authority) on behalf of the *Økonomi- og Erhvervsministeriet* (Ministry of Economics and Business Affairs) for an opinion on a proposal for a law amending the *Lov om investeringsforeninger og specialforeninger samt andre kollektive investeringsordninger m.v.* (Act on investment associations and special-purpose associations and other collective investment undertakings etc.) and the *Lov om finansiel virksomhed* (Financial Business Act) (hereinafter the ‘draft law’).
2. The ECB’s competence to deliver an opinion is based on Article 105(4) of the Treaty establishing the European Community and the sixth indent of Article 2(1) of the Council Decision (98/415/EC) of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions¹ as the draft law contains provisions applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council of the ECB has adopted this opinion.
3. The draft law will transpose into Danish law Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)². In addition, the draft law lays down a specific legal and supervisory basis for the establishment of Danish ‘hedge’ funds. As draft national legal acts exclusively transposing directives fall outside the scope of Article 2(1) of Council Decision 98/415/EC, this opinion is restricted to covering those provisions of the draft law which concern hedge funds and go beyond merely implementing a Community directive.

¹ OJ L 189, 3.7.1998, p. 42.

² OJ L 375, 31.12.1985, p. 3. Directive as last amended by Directive 2004/39/EC (OJ L 145, 30.4.2004, p. 1).

4. Under the draft law, hedge funds catering to a wide circle or the general public will be subject to approval by the Danish Financial Supervisory Authority. It will be optional for funds which have only one or a few members to make themselves subject to such approval and thereby become subject to the supervisory regime established by the draft law. The funds which are approved will not be subject to any restrictions in terms of the type of instruments they may invest in or their diversification, but the board of each such fund will be required to lay down a risk profile to be communicated to the public by means of prospectuses and by means of its by-laws. The risk profile itself will not be subject to approval, but the depositary of the fund, which will be subject to approval by the Danish Financial Supervisory Authority, will be required to ensure compliance with this risk profile and to report any non-compliance to the Danish Financial Supervisory Authority. Approved hedge funds will be required to fulfil the general provisions of the Act on investment associations and special-purpose associations and other collective investment undertakings etc. as regards supervision, rules on prospectuses, audit and corporate governance requirements. As a consequence of creating a specific system for the supervision of Danish hedge funds, additional amendments to the rules and regulations governing investment management companies and depositaries are also proposed to enable these undertakings to act as depositaries for hedge funds.
5. Hedge funds have attracted the attention of the global financial community because of their considerable growth and proliferation as an increasingly popular alternative investment vehicle. The pace of growth of the hedge fund industry indicates that hedge funds are becoming important non-bank financial intermediaries with potential implications for the stability of the financial system, especially because of their often active and highly leveraged trading strategies and their growing links to the banking sector. Against this backdrop, the ECB welcomes the fact that the Danish authorities have consulted it on the draft law and would like to emphasise the importance of doing so.
6. While it is widely recognised that close monitoring of the development of the hedge funds industry is necessary, public debate on whether this should involve direct regulation of hedge funds is still ongoing. At the international level, both the Financial Stability Forum in its *'Report of the working group on highly leveraged financial institutions'*³ and the IMF in its annual *'Global Financial Stability Report'*⁴ have expressed support for efforts by authorities to better understand, monitor and influence hedge fund activities. More recently, developments in this direction occurred in the United States, with the recent adoption by the US Securities and Exchange Commission (SEC) of a new rule which will require many hitherto unregulated advisers to hedge (or 'private') funds to register with the SEC by 2006⁵. At the European level, on 15 January 2004 the European Parliament adopted a resolution on hedge funds based on a report by its Economic and Monetary

³ Dated 5 April 2000.

⁴ Dated 13 September 2004.

⁵ Rule 203(b)(3)-2 under the US Investment Advisers Act of 1940, adopted on 26 October 2004.

Affairs Committee, which proposed a light regulatory regime for hedge funds⁶. The ECB is studying the implications of hedge funds for financial stability and the possible need for a regulatory regime with a view to defining a policy stance in due course. Hence, the ECB would like to note that its views expressed in this opinion are without prejudice to the future development of its general position on this issue. This opinion is therefore restricted to technical comments.

7. The ECB welcomes the overall thrust of the draft law since it lays down a number of disclosure requirements which will enhance transparency in relation to the activities of hedge funds and the potential risks incurred. The ECB would like to make two remarks, however. First, the draft law only applies a compulsory supervisory approval system to hedge funds catering to a wide circle or to the general public while such a system remains optional for other hedge funds. However, hedge funds may incur substantial leverage and liquidity risks with possible implications for financial stability regardless of the scope of distribution to investors. Therefore, a possible extension of the disclosure requirements set out in the draft law also to those hedge funds which are owned only by a limited number of members could be explored. Second, the disclosure requirements provided for are not very specific, especially with regard to the components of the risk profile and the ongoing information to be provided to investors. In the light of the complexity inherent to hedge funds' activities and the limited number of available market benchmarks the possibility of more detailed provisions could be assessed with a view to ensuring that investors - particularly in the retail sector - are sufficiently informed to adequately assess the risk and performance of hedge funds.
8. The ECB observes, as also stated in the general explanatory notes to the draft law, that there is no internationally recognised definition of the term 'hedge fund'. The term covers a wide range of funds with various investment philosophies and degrees of exposure to risk. However, the general notes to the draft law identify the following common elements which would seem to characterise all hedge funds: (i) clear profit objectives and investment strategies, (ii) no legislative limitations on the investment freedom of the funds as regards markets, instruments, diversification or leverage, and (iii) that the investment adviser invests considerable assets in the fund in return for performance-related fees. Many different types of entities would be covered by these three elements. It is noted that the draft law does not contain any provisions which establish precisely the scope of such funds. Rather, in order to be able to identify the funds covered by the draft law, the draft law applies a definition (see Article 114a of the draft law) in the sense that it lays down a general description of the activities which hedge funds may perform. For reasons of legal certainty it might perhaps be helpful to consider whether a more precise definition could be introduced stipulating how hedge funds can be distinguished from other kinds of investment funds regulated (or not regulated) by Danish law.

⁶ European Parliament resolution P5 TA(2004)0031 on the future of hedge funds and derivatives (2003/2082 (INI)).

9. The ECB confirms that it has no objection to the competent national authorities making this opinion publicly available at their discretion. This opinion will be published on the ECB's website six months after the date of its adoption.

Done at Frankfurt am Main, 14 December 2004.

[signed]

The President of the ECB

Jean-Claude TRICHET