EUROPEAN CENTRAL BANK

EUROSYSTEM

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EUROPEAN COMMISSION'S CONSULTATION ON HEDGE FUNDS

EUROSYSTEM CONTRIBUTION

As a part of a wider review of the regulatory and supervisory framework for EU financial markets, the European Commission has launched **a public consultation on hedge funds**. Besides helping to shape the European response to potential vulnerabilities in the financial system originating from the hedge fund sector, the outcome of the consultation will serve as a basis for the European input into reflections on hedge funds at the international level under the auspices of the G20 and the International Organization of Securities Commissions (IOSCO).

This note provides the preliminary views of the Eurosystem on some questions raised in the consultation. In particular, it concentrates on the issues relating to systemic risks and market efficiency and integrity (questions 1-8), which are closest to the competencies and the interests of the Eurosystem.

Should the Commission eventually pursue a regulatory initiative, this contribution is without prejudice to the opinion to be adopted by the Eurosystem when it is formally consulted on the Commission's proposal pursuant to Article 105(4) of the Treaty.

The Eurosystem contribution is structured along the lines of the specific questions posed in the Commission consultation paper.

(1) Are the above considerations [on the distinctive characteristics of hedge funds] sufficient to distinguish hedge funds from other actors in financial markets (especially other leveraged institutions or funds)? If not, what other/additional elements should be taken into account? Do their distinct features justify a targeted assessment of their activities?

The Eurosystem sees merit in focusing on all types of leveraged and actively managed private pools of capital. In particular, leverage could be used as a distinguishing feature because it generates certain risks to financial stability which may justify targeted action.

As noted in the consultation paper, a wide spectrum of private pools of capital are frequently referred to as hedge funds, although only some of them follow hedged equity investment strategies similar to those traditionally associated with hedge funds.[1] These funds pursue a relatively unconstrained form of active asset management and usually have many similar characteristics, such as performance-based fees, investor redemption restrictions, a focus on absolute returns under all market conditions, flexible investment strategies that can involve short-selling, leverage and positioning with derivatives.[2] However, none of these features appears to be unique to hedge funds; many of them increasingly feature in other parts of the active asset management industry and in the activities of other financial intermediaries. In practice, almost any active investment fund can be marketed as a hedge fund. Consequently, it is very difficult to clearly distinguish hedge funds from other actively managed private pools of capital.

From a financial stability viewpoint, the use of leverage is an important feature that could be used for distinguishing hedge fund-like, actively managed and leveraged private pools of capital from other active, but unleveraged funds.[3] The use of leverage introduces certain vulnerabilities which may justify regulatory action and a targeted financial stability assessment. High leverage creates the risk of involuntary de-leveraging – e.g. owing to investment losses or tightened lending terms and conditions – which may have adverse implications for creditors and asset prices.[4] Consequently, it may be advisable to focus on all types of actively managed and leveraged private pools of capital.

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[1] See Loomis, C. J. (1966), "The Jones nobody keeps up with", *Fortune*, April.

[2] A. W. Jones, who is often credited with being a founder of one of the first hedge funds in 1949, reportedly said that a hedge fund is *always* leveraged and *always* carries at least some short positions. See Loomis, C. J. (1970), "Hard times come to the hedge funds", *Fortune*, January.

[3] Not all hedge funds use leverage, even though they usually can, and their average leverage may not necessarily be as high as is often believed. Some hedge fund investment strategies may indeed require relatively high levels of leverage, but even then the actual levels of leverage employed typically fall short of those common in banks.

[4] Forced de-leveraging can also occur as a result of investor redemptions, but hedge funds tend to have more restrictions on investor withdrawals than traditional open-end investment funds. This equips them with more possibilities to smooth out portfolio liquidations.

(2) Given the international dimension of hedge fund activity, will a purely European response be effective?

The Eurosystem is strongly in favour of an internationally coordinated response, given the highly international nature of the hedge fund industry. Most hedge funds are domiciled either in onshore non-EU jurisdictions or offshore financial centres with minimum regulatory coverage and favourable tax treatment. Hedge fund management firms, however, tend to be located in major financial centres and, at least in the EU, are registered and supervised by local authorities.

Consequently, any form of regulation aimed at hedge funds and/or hedge fund management firms would be most effective if it were well coordinated at the international level in order to avoid regulatory arbitrage and evasion. Uncoordinated efforts would fail to address macro-prudential concerns stemming from actively managed and leveraged funds that can be domiciled in various jurisdictions and have a global focus in their activities.

A European initiative can act as a first step towards a global consensus, but at the same time should take the competitiveness of EU-based hedge funds and hedge fund management firms into account. A "regulated in the EU" label could prove to be an advantage for some hedge fund-like private pools of capital. Moreover, a common EU regulatory regime would benefit market integration at the European level. Given the international character of the hedge fund value chain, a purely European response, if deemed necessary, might be most effective if directed towards asset managers and investors residing in the EU.

(3) Does recent experience require a reassessment of the systemic relevance of hedge funds?

Owing to the significance of the hedge fund sector to the major financial markets, the Eurosystem would strongly welcome more transparency and macro-prudential oversight of the hedge fund industry.[5]

Hedge funds are very dynamic participants in various financial markets. Consequently, they have been affected by – and have actively contributed to – the recent adverse developments in world financial markets.[6]

The turmoil has highlighted how high leverage, unstable funding sources and crowded trades[7] can contribute to adverse dynamics in market pricing patterns. Both the dynamic use of leverage and momentum-based or trend-following trading strategies can contribute to the pro-cyclical effect of hedge funds' activities on financial markets.[8] In addition, other risks related to the use of leverage and the active

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5 It is noted that both the CEBS and the BSC have undertaken risk assessments of the EU banking sector that include references to risks related to hedge funds.

6 See also, for example, ECB (2008), Financial Stability Review, December, pp. 44-47.

7 Crowded trades refer to a situation where a large number of investors attempt to exploit profitable opportunities using similar investment strategies, leading to similar, or crowded, investment exposures. The issue of crowded trades or, more precisely, the risk of large-scale collective exits from such trades, is not limited to hedge funds and other leveraged investors but applies to all market participants.

8 There are also many other active leveraged and unleveraged investors who also use pro-cyclical investment strategies. Moreover, pro-cyclicality is a broader issue for the whole financial system.

participation of these institutions in major financial markets increase their significance for financial stability.

The recent turmoil has not resulted in a systemic hedge fund-related incident. However, it does not mean that the occurrence of such an event can be excluded in the future. A disruption might, for example, involve a failure of a large, highly leveraged hedge fund, a group of medium-sized, leveraged hedge funds or a large number of smaller hedge funds following the same investment strategy involving active trading in major international markets. If other important leveraged investors were to have similar positions to those of the failing hedge funds, an abrupt unwinding and the associated sales of collateral could have unpredictable implications for market liquidity and asset prices, possibly exacerbating already existing vulnerabilities elsewhere in the financial system. The lack of reliable information on aggregate investment exposures and leverage in the sector calls for the strengthening of macro-prudential oversight of hedge funds' activities and the introduction of concomitant regulatory initiatives. Moreover, the same call should also apply equally to other leveraged institutions (e.g. the proprietary trading desk of major banks) that engage in hedge fund-like activities.

(4) Is the 'indirect regulation' of hedge fund leverage through prudential requirements on prime brokers still sufficient to insulate the banking system from the risks of hedge fund failure? Do we need alternative approaches?

Notwithstanding its support of the current international regulatory initiatives in the hedge fund sector, the Eurosystem considers that indirect regulation has also had its merits in the past and should be further enhanced.

In particular, the conditions for the success of indirect regulation have improved since the near-collapse of Long-Term Capital Management, a large and highly leveraged hedge fund, in September 1998. Prime broker banks have made substantial improvements in the way they manage their credit exposures to hedge funds. The use of collateral and advances in risk management, facilitated in part by the introduction of the Basel II framework, decrease the potential losses of individual banks on their direct credit exposures to hedge funds. Even in stressful times banks might be more affected indirectly via changes in asset prices or exposures to hedge funds' counterparties.

However, some areas for improvement remain. For example, creditor banks may not always have a complete and continuous picture of a hedge fund, owing to the use of several prime brokers by hedge fund clients. Some banks may still face difficulties as regards timely aggregation of multiple exposures to individual hedge funds. Finally, despite internal risk controls and prudential safeguards, banks' risk appetite and lending terms tend to follow changes in market conditions in a pro-cyclical way. This calls for an enhancement of banks' risk management practices, particularly with respect to due diligence, risk measurement and risk mitigation. The Basel II framework lays ground for progress in this area.

Furthermore, the crisis pointed out a number of deficiencies in areas such as governance, risk management, valuation and the transparency of the hedge fund industry. To complement indirect regulation, the Eurosystem would support an improved disclosure framework of hedge funds vis-à-vis counterparties and investors as part of the unified best practices for the global hedge fund industry that are called for in the action plan of the G20 summit of November 2008. To enforce compliance of the industry with best practices, the obligation for hedge fund managers to submit themselves to third-party reviews could be introduced. In addition, it could be considered whether regulated institutional investors should be allowed to invest only in hedge funds managed by asset managers that comply with best practices.

(5) Do prudential authorities have the tools to monitor effectively exposures of the core financial system to hedge funds, or the contribution of hedge funds to asset price movements? If not, what types of information about hedge funds do prudential authorities need and how can it be provided?

The Eurosystem would support an internationally coordinated action to collect, consolidate and publish macro-prudential information about all actively managed and leveraged pools of capital.

The monitoring of the systemic impact of hedge funds would require high-quality information. Supervisory authorities have access to information that is necessary for monitoring banks' exposures, including exposures towards actively managed funds. However, the tools available to them to monitor the details and factors behind particular asset price movements on a close to real-time basis are limited.

In this regard, it is noteworthy that aggregate data on banks' exposures to hedge funds and other actively managed leveraged private pools of capital are not available. Moreover, there is no periodic information on aggregate leverage or broadly grouped investment exposures of hedge funds. There are no reliable data on the total size of the hedge fund sector either.[9] The coverage, scope and quality of information in existing and commercially available hedge fund databases is insufficient for macro-prudential monitoring, and the various hedge fund associations have not come up with a solution to consolidating the dispersed and patchy information. Enhanced fund-level and consolidated information on hedge funds' activities and the associated risks would help the monitoring and the assessment of financial stability by public authorities and also improve the effectiveness of overall market discipline.

The Eurosystem would support an initiative to collect, consolidate and make public macro-prudential information about actively managed and leveraged private pools of capital, including hedge funds. Given the global nature of the hedge fund sector, such an initiative should be internationally coordinated and take due account of already ongoing initiatives (e.g. under the auspices of the Bank for International Settlements). In this context, a registration rule for hedge funds or an obligation for hedge fund managers to inform about all managed hedge funds might need to be considered.

Meaningful comparison and easy aggregation would require a standardised reporting template. The minimum to-be-reported fund-level information could be similar to that typically provided to hedge fund databases, including the time series of investment returns and capital under management, and be enriched

[9] The European System of Central Banks (ESCB) is to start collecting some harmonised statistical information on the balance sheets of investment funds, including hedge funds, but this data will be confined to entities domiciled in the respective EU Member States.

with information on leverage and broadly grouped investment exposures. However, the scope, the frequency and the way of reporting merit further thinking and should also ensure a level playing field among various leveraged financial institutions that engage in hedge fund-like activities.

6) Has the recent reduction in hedge fund trading (due to reduced assets and leverage, and short-selling restrictions), affected the efficiency of financial markets? Has it led to better/worse price formation and trading conditions?

Every additional market participant provides complementary liquidity to the market and thereby contributes to market efficiency. However, owing to their active risk-taking and the frequent turnover of their portfolios, the contribution of hedge funds is certainly more significant than their net or even gross (leveraged) assets would suggest. Hedge funds are often liquidity providers even in markets trading simple instruments.

As the turmoil unfolded, hedge funds were forced to deleverage and to curtail their trading, owing to tighter credit terms applied by banks, investment losses and investor redemptions. Consequently, financial markets were deprived of their most active participants. Trading conditions suffered particularly in some financial markets for more complex financial instruments.

Although difficult to quantify in the current market conditions, financial market efficiency seems to have decreased owing to the recent reduction in trading. A macro-prudential approach to monitoring aggregate risk is advisable to prevent a process of disorderly de-leveraging and fire sales from threatening financial stability.

(7) Are there situations where short-selling can lead to distorted price signals and where restrictions on short-selling might be warranted?

The Eurosystem sees merit in considering globally coordinated regulation of naked short-selling[10] and introducing transparency rules for short positions in general.

Authorities and the academic literature have acknowledged that short-selling plays a positive role in the market in the long run.[11] Following the introduction of the short-selling bans, some evidence of a consequent decline in market efficiency for the affected stocks in the United Kingdom and the United

[10] Short-selling refers to the practice of selling shares without owning them, in the hope that it will be possible to buy them at a later point in time at a lower price and thus make a profit. If the shares are borrowed, the practice is called *covered* short-selling. *Naked* short-selling is the practice of selling stock without having a lending party, in the hope that one can be found later.

[11] In normal times, short-selling is considered to provide more efficient pricing, to decrease volatility and increase liquidity, and to improve possibilities for hedging and risk management. See e.g. the IOSCO media release of 2 October 2008 at www.iosco.org.

States has been documented in the academic literature.[12] But temporary restrictions on short-selling may be justified in specific cases, including during a financial crisis. In particular, short-sellers may target vulnerable financial institutions and may destabilise them by speculative actions, even though they would have survived otherwise. If the stock is in short supply, it may be difficult or costly to find a lender (needed for covered short-selling); therefore, short-sellers may decide not to borrow the shares, i.e. resort to naked short-selling. Because naked short-selling allows an unlimited number of shares to be sold short, short-sellers may manipulate price formation, further driving the stock price down and thereby lowering investor confidence.

Owing to the capacity of naked short-selling to manipulate price formation, a coordinated regulation of naked short-selling practices should be considered at international level. Moreover, the introduction of transparency rules for short positions is advisable, to improve price formation and market conditions. In fact, disclosing short positions that exceed a certain threshold increases the amount of information contained in stock prices, because investors may correctly attribute a price drop to short-selling trading. At the international level, IOSCO is pursuing coordinated action to establish common principles regarding naked short sales and reporting and delivery requirements.[13]

(8) Are there circumstances in which short-selling can threaten the integrity or stability of financial markets? In combating these practices, does it make sense to tighten controls on hedge funds, in particular, as opposed to general tightening of market abuse disciplines?

The Eurosystem is of the view that restricting short-selling may be advisable at times of systemic crises, as long as such restrictions are introduced in a coordinated manner and removed as soon as normal market conditions are re-established. Such rules should apply for all market participants alike.

Not imposing short-selling restrictions in systemic crises may make some financial institutions more vulnerable, thereby deepening a systemic crisis and contributing to a further loss of confidence. Therefore, the benefits of introducing temporary short-selling restrictions in terms of containing instability may exceed their potential efficiency costs in times of systemic crisis.

If all securities market participants are subject to the same regulation, there should be no case for additional oversight or regulation of hedge funds without introducing serious consideration of the unintended consequences that would likely result.

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[12] The effects have been measured in terms of increased bid-ask spreads, a decline in trade volumes and sluggish reactions to news regarding the stocks that were affected by the bans. See e.g. Bris (2008), "Short-selling activity in financial stocks and the SEC July 15th emergency order", mimeo, downloadable at www.arturobris.com; and Clifton and Snape (2008), "The effect of short-selling restrictions on liquidity: Evidence from the London Stock Exchange", policy note commissioned by the London Stock Exchange, 19 December.

[13] See e.g. the IOSCO media release of 25 November 2008 at www.iosco.org.