



FACULTY OF LAW
University of Lund

Carl Hagerman

European Hedge Fund Regulation –
An introduction to and a discussion of
the mitigation of the risks associated
with the hedge fund industry

Master thesis
20 points

Supervisor
Lars Gorton

Field of study
Financial Law

Semester
Autumn 07

Contents

SUMMARY	1
PREFACE	3
ABBREVIATIONS	4
1 INTRODUCTION	5
1.1 Background	5
1.2 Problem statement and statement of purpose	5
1.3 Method and material	6
1.4 Delimitations	7
1.5 Dispositions	7
2 HEDGE FUNDS	9
2.1 Risk and profit	9
2.2 Definition and Characteristics	9
2.3 History and background	12
2.4 Growth and developments in the industry	13
2.4.1 <i>Global growth</i>	14
2.4.2 <i>European growth</i>	14
2.5 Hedge fund structures	15
2.5.1 <i>Hedge fund managers</i>	15
2.5.2 <i>Domicile of European Union hedge funds</i>	16
2.5.3 <i>Prime brokers</i>	16
2.5.4 <i>Administrators</i>	16
2.5.5 <i>Custodians</i>	17
2.5.6 <i>Auditors</i>	17
2.5.7 <i>The importance of jurisdiction</i>	17
3 RISKS WITH HEDGE FUNDS	18
3.1 Risks to financial stability and market confidence – systematic risk.	18
3.1.1 <i>The Fall of Long Term Capital Management (LTCM) and the risk to financial stability</i>	19
3.1.2 <i>The risk of inaccurate asset valuation</i>	20
3.1.3 <i>Other risks relating to market confidence</i>	20
3.2 Risks to market cleanliness	21
3.2.1 <i>Trading on non-public information</i>	21

3.2.2	<i>Market manipulation</i>	21
3.3	Risk to financial crime objectives	22
3.3.1	<i>Fraud</i>	22
3.3.2	<i>Money laundering</i>	23
3.3.3	<i>Closing remarks regarding risks</i>	23
4	ANALYSIS OF THE NATIONAL REGULATION & EFFORTS ON MITIGATING THE RISKS	24
4.1	National risk mitigation – the UK	24
4.2	London as the financial centre in the EU	24
4.3	The FSA as a risk regulator	24
4.4	The FSA’s general principles	26
4.5	Regulated activities	27
4.6	Collective investment schemes	28
4.6.1	<i>Hedge Funds Domiciled in the UK</i>	28
4.6.2	<i>Hedge funds domiciled within the EU – UCITS</i>	29
4.7	The marketing of hedge funds in the UK	30
4.8	Regulation of hedge fund managers	31
4.8.1	<i>The Conduct of Business rules</i>	32
4.8.2	<i>The Market in Financial Instruments Directive (MiFID)</i>	32
4.8.3	<i>The supervision of hedge fund managers</i>	34
4.8.4	<i>Funds of hedge funds</i>	35
4.9	Financial Services Compensation Scheme (FSCS)	36
5	ANALYSIS OF THE EUROPEAN AND THE INTERNATIONAL SCOPE OF THE EFFORTS OF RISK MITIGATION	37
5.1	Financial stability and market confidence - systematic risk	38
5.1.1	<i>The Financial Stability Forum (FSF)</i>	38
5.1.2	<i>Highly leveraged institutions (HLIs)</i>	38
5.1.3	<i>The Basel Committee on Banking Supervision (The Committee) and Basel II - indirect regulation</i>	39
5.1.4	<i>The Capital Requirements Directive (CRD)</i>	40
5.1.5	<i>The public disclosure</i>	41
5.1.6	<i>Valuation risk mitigation</i>	42
5.2	The Market Abuse Directive	43
5.3	The Money Laundering Directive	44
6	COMPARATIVE OUTLOOK	46
6.1	What national legislative measures govern hedge funds	47

6.2	Is the term hedge fund defined	48
6.3	What types of hedge funds can be set up	49
6.4	Hedge funds permitted to advertise	49
6.5	Are there limits to how single hedge funds (SHFs) can invest?	50
6.6	Is the hedge fund manager regulated	51
6.7	Is the hedge fund itself regulated	52
7	CONCLUDING ANALYSIS AND ENDING THOUGHTS	53
7.1	Systematic Risk and Regulatory arbitrage - jurisdictions	53
7.2	The risk to the individual investor – (un)necessary?	54
7.3	Complex financial products and legislation.	56
7.4	Future challenges	56
	SUPPLEMENT A	59
	SUPPLEMENT B	60
	BIBLIOGRAPHY	61

Summary

The hedge fund industry has become one of the most creative and innovative areas within banking and finance during the past ten years. Its rapid growth and constant development has made it hard for regulators to mitigate the potential risks posed to investors and the financial system.

The aim of this thesis is to discuss the potential need for further regulation of hedge funds, mainly based on the concern for financial stability but also investor protection. I have given a brief description of what the hedge funds are, how they function, their legal status and the risks associated with the hedge fund industry. I have also described and analysed how the identified risks are mitigated through legislation, both on national and international levels.

The thesis aims to identify and briefly describe and analyse the rules affecting the hedge fund industry in the EU in general and in the UK in particular as the UK is the centre for hedge funds in the EU. It has also been my intention to discuss the regulatory regime's functionality and appropriateness in the global economy the funds exist and functions in and also the present and future developments regarding hedge fund risk mitigation.

In the thesis the reader will find a comparative chapter where I provide the reader with an overview of how different and diverse the hedge fund regulation throughout Europe is. In the chapter, comparative research material provided by IOSCO, PricewaterhouseCoopers and the European Fund and Asset Management is presented. I do not go in to details when describing the laws found in the different countries in the EU. The intention is to give the reader an idea of how diverse and dissimilar the different legislators' approaches can be, not to present a detailed description.

I draw three conclusions in this thesis. The first conclusion is that risks can never be truly mitigated as long as the funds can use regulatory arbitrage. The funds main concerns are low taxes and no disclosures. The funds have the possibilities to choose the most favourable jurisdiction and if one country changes its rules, taxes, disclosure requirements etc; the fund, its managers and administrators can easily move. The hedge fund industry is a source of income for countries and no country wishes the industry to change jurisdiction which would even further reduce the effects of the authorities' attempts to mitigate risks.

The second conclusion is that even though it is easy to find risks associated with hedge funds, we must not forget why the funds exist to begin with: there is a demand for them. If it were not for the investors' demand for the funds, there would not be a hedge fund industry. I argue that the legislator should not impose too many rules, especially not on fund of hedge funds.

Investors must have the ability to make informed decisions regarding their investment activities and the states should not stop individuals trying to diversify their portfolios.

My third conclusion is that it is in the interest of everyone if the financial markets were regulated by those who fully understands them. Parliaments and politicians do not decide which advanced pharmaceuticals should be allowed to be sold to the public, a special authority does. It is my view that it is in the best interest of the consumer and the society if the financial authorities across the globe could all use an ad-hoc approach which would allow them to quickly react to potential threats to consumers and the financial system.

While writing this thesis, I have realised that it is not possible to limit the discussion to include only legal issues. To mitigate any risks through regulation demands a full understanding of the potential effects of that regulation so that any unnecessary loss to the economy can be avoided. In order to efficiently discuss any regulation in the complex world of the global economy; one must not only have a profound knowledge in the discipline of law, but also in the disciplines of finance and economics.

Preface

The hedge fund industry has become one of the most creative and innovative areas within banking and finance during the past ten years. Its rapid growth and constant development has made it hard for regulators to mitigate the potential risks posed to investors and the financial system. While writing this thesis, I have realised that it is not possible to limit the discussion to include only legal issues. To mitigate any risks through regulation demands a full understanding of the potential effects of that regulation so that any unnecessary loss to the economy can be avoided. In order to efficiently discuss any regulation in the complex world of the global economy; one must not only have a profound knowledge in the discipline of law, but also in the disciplines of finance and economics.

I would like to thank Professor Emeritus Lars Gorton at the Faculty of Law at Lund University, for his support and encouragement. The invaluable role played by Joakim Schaaf at the Swedish FSA cannot be ignored either as it was he who introduced me to the subject during an internship at the Swedish FSA in 2004.

Abbreviations

AIMA	Alternative Investment Management Association
BIPRU	The FSA's Prudential sourcebook for Banks, Building Societies and Investment Firms Instrument
BIS	Bank for International Settlements
CFD	Contract For Difference
CIS	Collective Investment Scheme
COB	The FSA's Conduct of Business sourcebook
COLL	The FSA's Collective Investment Schemes sourcebook
CRD	Capital Requirements Directive
ECB	European Central Bank
EEA	European Economic Area (the 27 Member States of the European Union plus Iceland, Norway and Liechtenstein)
EEC	European Economic Community
EFAMA	European Fund and Asset Management Association
FSA	Financial Services Authority
FSCS	Financial Services Compensation Scheme
FSF	Financial Stability Forum
FSMA	Financial Services and Markets Act 2000
G7	The group of seven (Canada, France, Germany, Italy, Japan, UK., U.S.)
GENPRU	The FSA's General Prudential sourcebook
HLI	Highly Leveraged Institution
IFSL	International Financial Services London
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
LSE	London School of Economics
LTCM	Long Term Capital Management (a hedge fund)
MAD	Market Abuse Directive
MiFID	Market in Financial Instruments Directive
NEWCOB	The new COB that the FSA is preparing
OEIC	Open-Ended Investment Companies
OFC	Offshore Financial Centre
OTC	Over the Counter
SEC	Securities and Exchange Commission
SYSC	The FSA's Senior Management Arrangement, Systems and Controls sourcebook
UCITS	Undertakings for Collective Investment in Transferable Securities
The Committee	Basel Committee on Banking Supervision

1 Introduction

1.1 Background

During the past years, hedge funds have been mentioned increasingly more in the press all over the world. In 2005, 39,989 press articles mentioned “hedge funds”, 43% above the previous 2004 record and more than 100 articles a day¹. Only ten years ago, the hedge fund industry was seen as very small and merely a modest number of investors used hedge funds as a way of diversifying their portfolios and manage risk. Today, the hedge fund industry has become paramount and the growth has been incredible. There seems to be no end to the start-ups of funds².

As the active funds provide investors with possibilities of managing risk, and the markets with liquidity, one might think that the hedge funds are very much welcomed³. However, even though the funds are known to produce outstanding results for investors and taking part in large global acquisitions, they are also associated with committing frauds and speculating unscrupulously with different investments and currencies. The hunt for exceptional returns has resulted in huge hedge funds leveraging up.

Regulators, politicians and economists around the globe are not only concerned about the risks posed to individual investors in the form of frauds and mismanagement. There are also concerns regarding increased insider dealings and money laundering, but perhaps the main concern is that the funds might constitute a systematic risk to the global financial system, as some of the funds are everything but risk averse in their approach to investing. As will be seen, the investment methods hedge funds use can both decrease and increase the investment risk.

1.2 Problem statement and statement of purpose

The aim of this thesis is to discuss the potential need for further regulation of hedge funds, mainly based on the concern for financial stability but also investor protection. I intend to give a brief description of what the hedge funds are, how they function, their legal status and the risks associated with the hedge fund industry. I also want to describe and analyse how the

¹ “100 times a day, hedge funds and the media”; Waleck et Associates, March 2006. <http://www.walek.com/documents/WA100TimesaDay.pdf>

² See charts 1 & 2 in Supplement A.

³ Alan Greenspan, former chairman of the US Federal reserve commented on the benefits of hedge funds in his testimony before the Board of Governors of the Federal Reserve System at a Hearing before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 108th Congress, 2nd Session, July 20, 2004. Greenspan stressed that one of the main benefits of the hedge funds is that they “...eliminate the abnormal profits and the inefficiencies by aligning prices across markets and provides liquidity to markets”.

identified risks are mitigated through legislation, both on national and international levels.

The thesis aims to identify and briefly describe and analyse the rules affecting the hedge fund industry in the EU in general and in the UK in particular as the UK is the centre for hedge funds in the EU. It is also my intention to discuss the regulatory regime's functionality and appropriateness in the global economy the funds exist and functions in and also the present and future developments regarding hedge fund risk mitigation.

I hope that this paper will contribute to the research conducted in this area even though organisations such as BIS, IOSCO, EU etc are already paying plenty of attention to it. I wish that by writing this legal study, academics will be able to not only find the information needed to further study this area, but also to gain a good knowledge of the hedge fund industry and the regulation of the same. I further hope that professionals will be able to use this thesis as a way of navigating through the vast amount of publications that are to be found regarding hedge fund regulation and mitigation of risks.

1.3 Method and material

The method used is a traditional practical and dogmatic, with both descriptive and analytical elements. The legislation and legal framework, as it stands today, is studied, critically evaluated and analysed. I try to analyze the rules from a perspective of appropriateness, efficiency and suitability for the future.

The material I use in this analysis primarily consists of reports, online publications, and speeches by self-regulatory organisations, financial regulators and supervisors, as well as literature and articles. There is much more literature regarding hedge funds to be found within the fields of banking, finance and financial risk management than there is in law at this moment. Arguably, this is due to the fact that any legal analysis must be limited to certain jurisdictions, whereas the banking and financial viewpoint does not have this limitation and can be just as easily studied and commented in China as in the UK.

In this work, the material produced by the BIS, IOSCO and the EU has been used frequently. The publications by the UK Financial Services Authority have been used extensively as their expertise and viewpoints have been utterly useful to write this thesis. Critical views, both in favour and against the industry, have been found in the plethora of articles that have been written over the years. To ensure objectivity is equally as hard as it is important and in order to find a good balance, I have tried to use articles from many different sources.

The reader will find that most of my views, conclusions and opinions are found in the concluding chapter even though they can be found throughout

the paper, wherever I find it necessary or beneficial to the reader. I do not think that a regulatory discussion regarding hedge funds can be entirely objective, nor can any other discussion. There is always an element of subjectivity as there is a constant lack of evidence.

1.4 Delimitations

The largest hedge fund market is to be found in the US but I have chosen to focus on the EU as I find it more interesting. There is such a large quantity of different legislators, opinions and views found in the EU regarding ways of mitigating risks why the regulation found in the EU should, in my opinion, illustrate the principles of the efforts made more than enough. For those who wish to understand and study the U.S. regulation I recommend the book “U.S. Regulation of Hedge Funds”⁴.

Albeit this thesis is written at a Swedish university, I will not use the Swedish regulation to illustrate the risk mitigation found when exemplifying the regulation of the financial markets through national regulation. Due to the limited amount of pages at my disposal, I have had to prioritise. It is my opinion that both in my own interest and in the interest of the reader, I shall focus primarily on the UK regulation to illustrate the risk mitigation found in law as most hedge funds in the EU are found or does business in the UK.

I do not lay a claim on this paper being a complete guide to the regulation of hedge funds as there is no limit to the amount of material that can be written regarding the subject matter. For example, the tax regulation affects the industry largely and the tax aspect is very important to hedge funds when they choose where to domicile. Other aspects such as bankruptcy laws, private law or listing of hedge funds on the stock exchange have also been excluded⁵, as comprehensive assessments would deserve theses of their own. This thesis mainly focuses on the regulators’ attempts of preventing systematic and consumer risks and extending its scope further by adding additional pages regarding other matters would be in breach of the directives and objectives with which this thesis is produced. By focusing upon certain issues and jurisdictions, I do not in any way value the importance of other issues, other aspects and regulations in other jurisdictions.

1.5 Dispositions

The second chapter includes a description of the hedge fund industry, characteristics, history, developments and hedge fund structures in order to give the reader a concise background and understanding of the industry. Hedge funds are rather complex investment vehicles and it is important to

⁴ Hammer, Douglas; Haynes, Geoffrey; Reiser, Carolyn S, The American Bar Association, 2005.

⁵ For more information regarding the listing of hedge funds, please see: White, B. And Mackintosh, J., “Top hedge fund AQR eyes public offering”, *Financial Times*, April 21 2007.

know how they function and how they are structured in order to understand the risks that are inherent to the industry.

The third chapter describes the potential risks the hedge funds constitute to the investors of the funds and to the global financial system. Earlier defaults, financial crises, frauds, insider dealings, market manipulations etc, will be described. The risks are effects of how the funds operate and invest their capital, described in chapter 2.

The fourth chapter will provide the reader with an example of how a regulator has chosen to deal with the risks that are associated with the hedge fund industry, mainly from an investor's point of view. In this chapter, I have chosen to use the regulation found in the United Kingdom to illustrate how risks can be mitigated. The regulation will be presented and analysed. The UK is used for two reasons: first, the UK is the hedge fund centre of Europe and second, London is the financial centre of the world. It must be noted that the regulation found in the UK is often based on EU directives.

The fifth chapter will deal with the international efforts that have been made and are made on the area of risk mitigation. This area is subject to extensive work from organisations such as the BIS, the IOSCO and the EU. The international work and agreements will be presented and analysed in this chapter. The chapter primarily focuses on the systematic risk to the financial system. The main EU regulations affecting the hedge fund industry in Europe are also covered.

In the sixth chapter, I will try to provide the reader with an overview of how different and diverse the hedge fund regulation throughout Europe is. In this chapter, comparative research material provided by IOSCO, PricewaterhouseCoopers and the European Fund and Asset Management is presented. In this chapter, I do not go in to details when describing the laws found in the different countries in the EU. The intention is to give the reader an idea of how diverse and dissimilar the different legislators' approaches can be, not to present a detailed description. A detailed description would be outside of the scope of this thesis that aims to focus on the principles of risk mitigation, not the detailed rules found throughout the world.

The seventh and last chapter will include my conclusions and opinions about the present and future risk mitigation regarding the hedge fund industry. I will here try to summarize and critically analyse the main problems with the present national and international regulation even though that is also done throughout the work. I will give my views of how to best create an efficient and lucrative hedge fund industry in Europe.

In Supplement A and B I have collected various data and diagrams that illustrates the growth of the industry, hedge fund structures, leverage, investment strategies etc. The idea is to make it easier for the reader to understand the industry as such.

2 Hedge funds

In order to fully understand the regulation regarding these investment vehicles named Hedge Funds it is important to understand how they function. When one understands how they function, it is much easier to see that there are risks associated with their way of investing, both to investors and to the financial markets. The risks and the regulations are effects of the complex investments methods used by hedge funds, which is why understanding the background and the strategies is crucial. In this chapter, I will try to give a brief description of the hedge funds' strategies and the background of the hedge fund industry.

2.1 Risk and profit

Risk is one of the fundamental features in financing. There is always a risk involved when it comes to investing. What an investor is paid for when he is making an investment is essentially the risk the investor is prepared to take on. Generally, if there is no risk, there is no profit to be made. Hedge funds are investment vehicles that try to reduce the investor's risk of losing capital as much as possible but at the same time produce a high return for the investor. In order to do this, hedge funds, among other things, look for investments that differ from the investments that are accessible for mutual funds for example⁶.

2.2 Definition and Characteristics

There is no general consensus regarding what a hedge fund really is, nor are there hardly any legal definitions in the different regulatory regimes throughout Europe and the world⁷. Many jurisdictions, including the members of IOSCO, do not have one at all⁸. The U.S. President's Working Group has used a definition that can summate the hedge fund industry: "*any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public*"⁹ but that definition would include other funds such as private equity funds and venture capital funds which would be misleading. The nature of the financial markets and the constant developments in investment strategies makes it hard to define exactly the concept of hedge funds. "To hedge" originally means that one is trying to reduce one's risk of financial loss if

⁶ For more information about risk management and investing I recommend the book: '*Global Investment Risk Management*' by the author Ezra Zask (McGraw-Hill, 1999).

⁷ The European Commission's Internal Market and Services Discussion Group: "Report of the Alternative Investment Expert Group – Managing, Servicing and Marketing Hedge Funds in Europe", (ECEGHF), July, 2006. p. 10.

⁸ IOSCO Consultation Report. "*The regulatory environment for hedge funds. A survey and comparison*", March 2006, p 1.

⁹ U.S. President's Working Group on Financial Markets, "*Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*", 28 April 1999, p 1.

movements occur in the value of an owned asset. This can be done in many different ways, for example by buying options or futures.

When one speaks about hedge funds the concept “hedge” has a slightly different meaning than just risk reduction. Hedge Funds have the aim of producing absolute returns that in as much as possible do not correlate with any markets or trends¹⁰ which must be differentiated from mutual funds who tries to produce positive returns in relation to an index used as a benchmark¹¹. Therefore, the hedge funds do not necessarily use methods of hedging to reduce risk but to produce absolute returns independent of markets movements, sometimes by actually increasing the risk. A hedge fund is hence not a vehicle that is to be used in order to insure the value of an asset. Derivatives can be used to buy insurance in the markets but that must be differentiated from hedge funds. In general, hedge funds are investment vehicles and not insurance products but if the hedge fund has a specific aim and is designed by its managers to insure an underlying asset against a certain risk, then that specific fund can in practice be used as an “insurance company”¹².

The objectives of hedge funds are to produce returns to its investors in whatever way is legally possible. Therefore, the funds invest in anything it regards as profitable, regardless of the asset class, jurisdiction or method. Hedge fund managers all use different strategies and there are plenty of funds that do not deal with securities at all. The development is constant and there appears to be no limit in which asset classes the hedge funds can invest in, let it be material or immaterial assets classes. For example: in 2005 when the investor Malcom Glazer took over the football club Manchester United, it was a group of hedge funds who provided Glazer with the funds, advised and facilitated the process¹³. However, there seem to be some key characteristics that can be connected with the hedge fund industry:

Management techniques often include:

- Short selling – This method is used when a fund manager believes an asset to be overvalued and/or expects the asset to depreciate in value. What the manager does is that he borrows the asset from another investor in return for interest payments on the asset’s market value at the time of the loan until the asset is returned to the investor at a future date. In theory, after the manager has borrowed the asset he sells it and buys it back later at a lower price, profiting from the difference between what he

¹⁰ IOSCO: “Final Report – The Regulatory environment for hedge funds, a survey and comparison”, November 2006, p. 12.

¹¹ For more information about the differences between hedge funds and mutual funds, please see: Harper, “Introduction to Hedge Funds – Part one” *Investopedia* November 23, 2003 on: <http://www.investopedia.com/articles/03/112603.asp>

¹² However interesting, discussing the possible legal effects of this is outside the scope of this thesis and I will not discuss the insurance aspect.

¹³ Jenkins, “The long and short”, *The Guardian*, September 24, 2005.

sold the asset for minus interest payments and expenses for buying the asset back.

- Investing in derivatives for investment purposes – Derivatives are financial instruments that derive their value from that of an underlying asset or index. There are two main types: contracts for future delivery of an asset or commodity at a specified price, and options that give one party the opportunity to buy from or sell to the other side an asset or commodity at a prearranged price. Derivatives can be used to manage risk or can themselves be traded speculatively¹⁴.
- Leveraging – The use of borrowing to finance the purchase of assets to be held in a fund. Borrowing exposes a fund to a liability as the debt must ultimately be repaid from the fund. Hedge funds leverage to achieve higher exposure, hence multiplying the effect of returns (or potentially losses) on their investors' capital¹⁵.
- Arbitraging – This method is used for producing risk free profits. The funds try to capture the returns of finding inaccurately priced assets in the market place. In accordance with the efficient market hypothesis¹⁶, arbitrage opportunities are very hard to find which has prompted the development of computer-trading where computers are programmed to find inefficiencies in the marketplaces¹⁷.

There are as many different hedge fund strategies as there are ways to produce positive returns on investments and the strategies above are just the most common. Statistical arbitrage; emerging markets; algorithmic trades; macro trends; equity hedge; event driven etc are just a few of the strategies used¹⁸.

Other typical characteristics for hedge funds are:

- High minimum investment limits – The funds often invest in illiquid products or event driven strategies and this often results

¹⁴ For more information regarding derivatives and their pricing, please see Hull, John C (2002): *Options, Futures and Other Derivatives*, 5th ed. Prentice-Hall.

¹⁵ The Financial Services Authority Discussion paper 05/03 (DP05/3), '*Wider-range Retail Investment Products – Consumer protection in a rapidly changing world*', 2005, p. 3. Also see chart 10 in Supplement A.

¹⁶ Fama, Eugene, "The Behaviour of Stock Market Prices" *Journal of Business*, January 1965.

¹⁷ For more general information about computer-trading's early usage and effects, please see: Eichenwald, "Computer-trading outcry forcing change" *The New York Times* November 2, 1989.

¹⁸ The Financial Services Authority Discussion paper 05/04 (DP05/4), '*Hedge Funds: A discussion of risk and regulatory engagement*', 2005, p. 12. Also see chart 12 in Supplement A.

in capital being tied up and not easily accessible for the fund. This, together with the manager's wish of not having to spend too much time administrating the money flowing in and out of the fund due to a large number of private investors withdrawals and diverse wishes, have produced thresholds of self-imposed minimum investment limits that will facilitate the managers work. The minimum investment limits often amounts to £50 000 even though lower limits have become more common¹⁹.

- The charging of performance fees on top of management fees – Many funds charge a 1% management fee and a 20% performance fee on the results produced²⁰.
- Broad mandates - Which give the flexibility that makes it possible for the manager to use many different types of strategies.
- High trading volumes – sometimes the funds trade on exchanges just to hide their real strategies²¹.

2.3 History and background

The American Alfred Winslow Jones started the first fund that can be described as a hedge fund in 1949. He invested by borrowing money when he bought shares, using the underlying shares as security for the loan (leveraging) and also by borrowing shares in order to sell them and later buy them back at a lower price (short selling). Jones also used performance fees, which entitled him to a certain percentage of any profits the fund made²².

Carol J Loomis used the term 'hedge fund' in an article in Fortune magazine in 1966 where she discussed Jones's strategies and actions²³. By setting up his fund as a limited partnership; Jones had avoided the reporting requirements and investment restrictions mutual funds were subjected to. What caught the magazines attention was how Jones had outperformed traditional investments. During the period 1955-1965, Jones fund had returned 670 percent, which was outstanding in comparison to other investments.

What one must keep in mind though is that even though Jones could use a more flexible way of investing than mutual funds, there was also another

¹⁹ DP05/4 p. 14.

²⁰ The International Financial Services' (IFSL) report: "Hedge Funds", March, 2006, p. 4.

²¹ DP05/4 p. 11. Also see: IOSCO: "Final Report – The Regulatory environment for hedge funds, a survey and comparison", November 2006, p. 5.

²² Note: The usage of performance fees is very much associated with the investor Benjamin Graham who used it half a century earlier in a partnership. Graham is the author behind the legendary books *Security Analysis* (written together with David Dodd) and *The Intelligent Investor*. Graham is also Warren Buffet's former teacher.

²³ Loomis, "The Jones nobody keeps up with" Fortune magazine April 1966.

type of risk associated with investing in Jones partnership, which will be looked into in chapter 3.

After the article, more and more investors have adhered to the belief that it is possible and more profitable to produce absolute returns rather than relative returns.

2.4 Growth and developments in the industry

Because of the possibilities associated with hedge funds and the returns the funds have produced in the past, the industry has grown rapidly over the past years²⁴. As the investment methods used by the funds can function as both reducing the risks but at the same time increasing the returns, and this independently of the general market direction, the funds have gained in popularity²⁵. Since 1997 hedge funds have generated positive returns in every year, mutual funds have not. In addition, stock market indexes have not gone up every year since 1997. However, hedge funds have performed less well than equities in recent years²⁶ but then one must keep in mind that the hedge funds' returns have less volatility²⁷.

As the sector's performance has generally been outstanding, it has in turn attracted a broader range of investors²⁸. The normal investor used to be a wealthy individual but because of the possibility to make money in both bear- and bull markets; institutional investors use hedge funds increasingly more, which can be seen in the charts 6 & 7 in Supplement A.

Since the funds, as they function now, are not generally subjected to legislation²⁹, they can practically invest their assets in whatever way they want and this together with the high performance fees has attracted the best investment managers in the world to the sector³⁰. The highest paid investment manager in the world in 2006 was Jim Simons, of Renaissance Technologies, who earned \$1.7 billion. The combined earnings of the world's top 25 hedge fund managers of almost \$15bn exceeded the national income of Jordan last year and three individuals took home more than \$1bn, according to an annual industry survey³¹.

²⁴ See chart 1 in Supplement A.

²⁵ The ECB compared data from 1994 to 2004 and found that all correlation coefficients between hedge fund family indices and major stock market indices were small and even negative in some cases. For more on this, please see: ECB Occasional papers, "*Hedge funds and their implications for financial stability*", August 2005.

²⁶ See chart 11 in Supplement A.

²⁷ International Financial Services London (IFSL) Report: "*International Financial Markets in the UK*", November 2006 (IFSL06), p. 12.

²⁸ See charts 6 & 7 in Supplement A.

²⁹ More on this in chapters 4-5.

³⁰ DP05/4 p. 13.

³¹ Taub, "Alpha Profiles the Top 25 Money Makers" *Alpha Magazine* April 20, 2007. See: <http://www.alphamagazine.com/Article.aspx?ArticleID=1328500&PositionID=25424>

2.4.1 Global growth

Since the hedge fund industry is largely unregulated and of an unclear and undefined nature, it is difficult to assess how many funds are operating. Private Equity funds are very often incorporated and set up in the same way and in the same jurisdictions as hedge funds yet their investment strategies differ significantly which is why they should not be mistaken as hedge funds³². Most data sources estimated the amount of hedge funds in the world to be around 9000 in 2005, a 6% increase from the previous year. Assets being under management of hedge funds or funds of hedge funds in 2006 were estimated to somewhere between \$1.2 – \$1.5 trillion. At the end of 2004, assets managed by hedge funds represented 2.17% of the global assets managed by insurance, pension or investment funds. In 1998 this figure was 0.70%³³. However, there are also funds that fail to produce the desired returns, attract too few investors or have grown too big and are closed down. 5% of the funds are closed down for various reasons every year and there are indications that the number is rising³⁴.

As the growth is so tremendous and more and more investors use hedge funds, there are also more investors affected by the risks involved. Hedge funds can no longer be considered as exotic products and the large amount of investors using hedge funds needs regulations that protect them. In addition, as the amount of funds under management has grown, the movement of such large sums of capital can affect the global markets and in the end, financial stability which is why governments, regulators and legislators have shown a growing interest in the industry.

2.4.2 European growth

The market for hedge funds in Europe has increased monumentally in just a few years. The European market has been at the forefront of the global growth and European Union hedge funds have at present more than \$325 billion in assets. The number of hedge funds amounted to around 1250 in 2006. The term “European Union Hedge Funds” refers to hedge funds either incorporated or organised in the European Union and/or with managers incorporated or domiciled in the European Union. This includes funds that are managed inside the EU but are domiciled outside of the EU and vice versa.

The average EU hedge fund had \$258 million in assets in 2006 but this figure varied depending on which country one looked at. For example, in

³² For more information regarding Private Equity Funds, please see: The European Commission’s Internal Market and Services Discussion Group: “Report of the Alternative Investment Expert Group – Developing European Private Equity”, July, 2006.

³³ See: Schurr, “Global hedge funds top \$1,500bn” *Financial Times* March 27, 2006. and ECEGHF p. 13. Also see charts 1 & 2 in Supplement A.

³⁴ DP05/4 p. 13.

the UK the average size was \$325 million and in France \$181 million just to illustrate differences.³⁵

2.5 Hedge fund structures

In order to understand all the risks associated with hedge funds one must not only understand the investment strategies used but also how different hedge funds are structured compared to mutual funds. The structure is also an important factor when estimating the risks, which will be seen in chapter 3. The investment strategies relates to how the funds invests the fund's capital whereas the structures relates to from where and under which rules the funds invests and operates.

Most hedge funds are domiciled in offshore jurisdictions since the EU countries' tax regimes are unfavourable in comparison. Funds domiciled in an EU country are usually subjects to corporation tax on income and capital gains whereas in Cayman Island and other favourable jurisdictions of incorporation they are not subject to any tax or auditing at all. Common hedge fund structures often involve a combination of entities whose legal form varies. To give the reader an idea of how a common structure looks like there is an illustration of a typical hedge fund structure to be found in supplement B and chart 16 in Supplement A.

Hedge funds are usually located in a mixture of onshore major financial centres and offshore low tax and light-touch regulatory regimes. Different aspects such as tax efficiency, proximity to financial markets, access to skilled professionals, access to potential investors and beneficial regulation determine the optimal location of each entity within the structure³⁶. Funds managed in the EU often have the following structures:

2.5.1 Hedge fund managers

The hedge fund manager of a hedge fund consults on what the fund should invest in. The hedge fund manager is mostly structured as a separate legal person to the hedge fund, but in effect; it is the hedge fund manager that is running the fund. Hedge fund managers located within the territory of the EU member states are subject to an authorisation and a supervision regime. London is Europe's leading centre for the management of hedge funds. At a global level, London is the second centre of management after New York. 79 %, or \$317 billion out of \$401 billion, of European hedge fund investments were managed out of the United Kingdom in June 2006. 21% of global hedge fund assets are estimated to be managed by hedge fund management groups in the United Kingdom, all of whom fully regulated by the UK Financial Services Authority (FSA)³⁷. These figures do not include

³⁵ ECEGHF p. 13.

³⁶ Structures vary considerably but for a description and illustration of a typical UK/EU hedge fund, please see Supplement B and chart 16 in Supplement A.

³⁷ IFSL06 p. 1.

fund of funds and investments from the US managed in Europe. If these are taken into account, London probably accounts for more than 90% of hedge funds assets managed in Europe³⁸.

2.5.2 Domicile of European Union hedge funds

Most hedge funds have the legal entities of companies, partnerships or trusts and are predominantly domiciled in offshore jurisdictions that do not impose tax on the funds, nor heavy auditing requirements if any³⁹. In January 2006, 55% of the total number of global hedge funds, managing 64% of total hedge fund assets, were registered offshore versus 34% in the U.S. and 9% in the EU. The most popular offshore location is the Cayman Islands with 63% of EU hedge fund assets followed by the British Virgin Islands (13%) and Bermuda (11%)⁴⁰.

2.5.3 Prime brokers

Prime brokers are generally investment banks such as Goldman Sachs, Morgan Stanley and Bear Sterns. Prime brokers are predominantly used by the hedge funds for financing, executing trades, stock lending and research but a rise in competition from this lucrative business has led to prime brokers increasing their range of services⁴¹. The hedge funds can now be provided with services such as on-line reporting, consulting, and referrals to lawyers, accountants and other service providers from their prime brokers. Most of the prime brokers' income derives from cash lending to support leverage and stock lending to facilitate short selling⁴². 90% of the prime brokers servicing EU hedge funds are located in London as the largest investment banks either are headquartered or have a major office in London. The prime brokers in London are authorised and supervised by the FSA⁴³.

2.5.4 Administrators

The extent to which hedge fund managers outsource administrative functions varies widely. Some funds choose to outsource all the administrative functions while others conduct all administration internally. Functions that are sometimes outsourced are accounting, investor services, risk analysis and performance measurements to third party administrators. The administrators may be subjects to licensing and auditing requirements in some offshore locations.

³⁸ *Ibid* p 13.

³⁹ I will not describe in detail how the legal entities functions as this thesis does not have the aim to go more deeply into corporate, partnership and trust law but rather to analyse the efforts of mitigating risks in the hedge fund industry. For more information about legal entities, please see: Pettet, *Company Law* (2nd ed., 2005).

⁴⁰ IFSL Report: "Hedge Funds", March 2007 (IFSLHF06), pp 2-7. Also see chart 17 in Supplement A.

⁴¹ See Table 2 regarding the largest prime brokers by market share in Supplement A. Also see chart 15 regarding what types of services are provided to hedge funds by banks.

⁴² DP05/4 p. 14.

⁴³ IFSLHF06, pp. 6-7. See also ECEGHF p. 14, DP05/4 pp 11, 14, 15.

2.5.5 Custodians

Custodians – The hedge funds assets are normally held with a custodian. This includes cash in the fund as well as the actual securities. Custodians may also control flow of capital to meet margin calls.

2.5.6 Auditors

Auditors – As many hedge funds are domiciled offshore in low regulatory environments, they are not required to have their financial statements audited. Some hedge funds however, especially if institutional investors are involved, may due to the contract between the fund and its investors, be obliged to undergo annual audits⁴⁴. It is not hard to understand that it can be rather risky to invest capital in a fund with no auditing requirements. More on this risk in chapter 3.

2.5.7 The importance of jurisdiction

It is very important to understand the implications of having parts of the entities needed to run a fund abroad as if the entity is outside of a country's jurisdiction; the country will find it hard to mitigate any risks found by imposing regulation as the regulation will not affect an entity found outside of the country's borders.

As can be seen with hedge funds, many entities are located in different jurisdictions depending on aspects such as tax efficiency, proximity to financial markets, access to skilled professionals, access to potential investors and beneficial regulation etc⁴⁵.

Mutual funds have very different structures to hedge funds and the most important difference is that all the entities important to run a mutual fund is predominantly found and domiciled inside of the EU. More on this to be found in chapters 4 and 5.

⁴⁴ IFSLHF06, p. 7.

⁴⁵ Structures vary considerably but for a description and illustration of a typical UK/EU hedge fund, please see Supplement B and chart 16 in Supplement A.

3 Risks with hedge funds

The hedge funds are very active and have thereby become important providers of liquidity on the financial markets. Even though the funds are only estimated to be managing 5% of the total managed assets in the world, they account for 33 % – 50 % of the daily activity on both the London and the New York stock exchanges⁴⁶. Hedge funds also offer great flexibility that can satisfy investor demands as they can invest the assets in as many ways as there are funds. However, despite the positive impacts of hedge funds, there are also risks⁴⁷. This chapter will describe the risks that are associated with the hedge funds. Earlier, we have seen that not only the investment strategies used by hedge funds affects the risks but also that the way the funds are structured affects the risks extraordinarily. Regulation is about considering costs and benefits⁴⁸ and in order to decide whether to regulate or not, one must understand all the costs and effects of both regulating and not regulating⁴⁹. A part of that is to properly assess the risks associated to the industry.

3.1 Risks to financial stability and market confidence – systematic risk.

A potential, even though somewhat unlikely, threat to financial stability could arise if a hedge fund or a cluster of hedge funds' strategies fails at the same time. The concern does not regard the funds' investors but rather the effect on the funds' counterparties and especially the prime brokers who often finance the funds. A significant failure can also seriously affect the price information and liquidities on the markets and the market confidence. An event that damaged market confidence could pose a threat to financial stability as many investors run for the exit doors at the same time and this fear of financial loss will then spread to the rest of the economy. In such a case, when the social cost is very high and there is a burden to the financial system as a whole, Goodhart argues that it is necessary to regulate⁵⁰.

⁴⁶ Figures from Credit Suisse First Boston (now Credit Suisse) 2005 as referred to in DP05/4 p. 14.

⁴⁷ For a brief and explanatory background, see Howard 'Shedding Light on Hedge Funds', FSA Speech, May 3, 2000, on www.fsa.gov.uk/Pages/Library/Communication/Speeches/2000/sp44.shtml

⁴⁸ For a detailed discussion regarding appropriate financial regulation, please see: Goodhart, Charles; Hartmann, Phillip; Llewellyn, David; Rojas-Suarez, Liliana and Weisbrod, Stephen, Financial Regulation: 'Why, how and where now?', Bank of England, 1998.

⁴⁹ For another detailed and interesting discussion regarding the need for hedge funds to be regulated, please see: Danielsson, Jon; Taylor, Ashley; Zigrand, Jean-Pierre, Highwaymen or Heroes: 'Should Hedge Funds be Regulated?', London School of Economics, September 2005.

⁵⁰ Goodhart, Charles; Hartmann, Phillip; Llewellyn, David; Rojas-Suarez, Liliana and Weisbrod, Stephen, Financial Regulation: 'Why, how and where now?', Bank of England, 1998, p. 14.

3.1.1 The Fall of Long Term Capital Management (LTCM) and the risk to financial stability

The fear for the identified risk of market instability described above caused a serious market disruption and eroded confidence in the financial strength of the hedge funds and their counterparties in 1998 when the fund LTCM nearly collapsed. LTCM was a gigantic fund and had around \$1400 billion in gross exposures⁵¹. LTCM invested by profiting from a complex model that was based on price differences in the bond markets and as the profits were very small they used gigantic leverage to produce outstanding returns. At one time, the fund had a leverage ratio of over 50 to 1⁵².

In the fall of 1998, the Russian government did something that nobody had even considered to be a risk: the government defaulted on their own government bonds. Investors were panicked and the sell off affected the LTCM's model in a very negative way, especially as LTCM was highly leveraged. The losses were so substantial that they directly affected LTCM's counterparties and the Federal Reserve Bank of New York saw no other way to solve the situation than to organize a bailout of \$3.625 billion by the major creditors in order to avoid a wider collapse in the financial markets⁵³. If the bailout would not have been organized, the problems and defaults could have echoed through the financial markets and created massive instability which could have resulted in a crash.

Since the near-collapse of LTCM, the amount of leverage used by hedge funds declined as can be seen in chart 10 in supplement A. The failure also had the effect that the problem with high leverage and unforeseen events has been discussed in various forums throughout the world. Today it would be impossible for a prime broker and professional creditor in the EU to provide a fund with enough credit for the fund to use such high leverage. The Basel II's provisions regarding risks that were implemented through the Capital Markets Directive makes it impossible as risks must be assessed by the prime brokers and as they are mostly located in London, they must obey the requirements. More on this in the chapter 5.

The leverage aside, LTCM not only had a problem due to the leverage, due to the products needed for the strategy, LTCM had a problem we have now seen during the credit crunch of 2007: liquidity. When LTCM tried to close its positions, it moved the markets as it traded in illiquid products.

⁵¹ On its board of directors were Myron Scholes and Robert C. Merton, who shared the 1997 Nobel Memorial Prize in Economics. Even Nobel Prize winners can sometimes fail when trying to accurately assess the risks involved.

⁵² Testimony of Richard R. Lindsey, Director SEC Division of Market Regulation before the House Committee on Banking and Financial Services, Concerning Hedge Fund Activities in the U.S. Financial Markets:

www.sec.gov/news/testimony/testarchive/1998/tsty1498.htm

⁵³ European Parliament's draft report: "*The international monetary system – how to make it work better and avoid future crises*" (2000/2017(INI)). July 2001. For further reading, please see: Lowenstein, Roger (2000). *When Genius Failed: The Rise and Fall of Long-Term Capital Management*. Random House.

Another large hedge fund that has failed is Amaranth. In 2006, Amaranth invested in the energy markets and had a debt/equity ratio of 5. The markets went against Amaranth but as the leverage was not nearly as high as it was in LTCM and Amaranth also invested in liquid markets, the financial industry was not hit, only the funds investors⁵⁴.

3.1.2 The risk of inaccurate asset valuation

There are many operational risks inherent in the valuation of hedge fund assets and this may affect investors' ability to accurately assess hedge fund manager performance and thereby take informed decisions regarding their investments. This may affect the price information in hedge fund shares and the markets in general, which therefore might affect market quality.

Hedge funds often invest in complex or illiquid assets for which there is no public screen price. Mutual funds do not. To perform the valuation of illiquid or complex assets, the administrators are forced to rely upon a combination of:

- Valuation models that are often developed by the hedge fund manager itself.
- Counterparty quotes.
- Direct valuations from the hedge fund manager.

It is not hard to see that this calls into question whether the valuations are correct and truly independent. Conflict of interests can easily arise. High performance fees can create incentives for the funds to issue false valuations and results, which can give the manager a high commission one year and make the fund insolvent the next⁵⁵.

An independent valuation of UK-managed hedge funds, is typically sought from a third party administrator. Hedge funds are not required to have independent depositaries or trustees whose role is to ensure that the funds' assets are valued in line with regulatory rules, unlike the situation for regulated Collective Investment Schemes (CIS)(mutual funds), which will be seen in chapter 4 regarding CISs.

3.1.3 Other risks relating to market confidence

- Insufficient information for regulators – Regulators have insufficient reliable and comparable data on which to base informed decisions

⁵⁴ Ann Davis, Henny Sender, and Gregory Zuckerman, "What Went Wrong at Amaranth," *The Wall Street Journal*, Sept. 20, 2006.

⁵⁵ In 2006, there was a problem with valuations in a fund and the responsible manager will not be able to undertake any controlled functions in relation to regulated activities until March 2009, see: the FSA's '*Hedge fund manager withdraws from industry following fund overvaluation*', March 23, 2006, on: www.fsa.gov.uk/Pages/Library/Communication/Statements/2006/hedge_fund.shtml

about risk and consequently proportionate regulatory action to mitigate that risk due to the fact that many funds operate in low-regulatory jurisdictions.

- Issues regarding control – Some managers might not have the optimal skill set or incentives to create an effective control infrastructure as many of the hedge fund managers have a background as traders rather than as fund managers⁵⁶.

3.2 Risks to market cleanliness

3.2.1 Trading on non-public information

Concerns have been raised that some hedge funds are pushing at the boundaries of acceptable practice in relation to trading based on non-public information. The risk for hedge funds using insider information as defined in the Market Abuse Directive⁵⁷ (more on this in chapter 5.2) is perhaps particularly acute in event driven strategies and convertible arbitrage. The whole idea of the investment strategy in these types of strategies is to profit from mergers and acquisitions, making it very valuable to get in before the takeover has been officially announced. It has been noted that the market moves before block trades and large bought deals⁵⁸. This risk is not associated with mutual funds to the same extent as the rules governing mutual funds prohibits mutual funds to only focus on event driven strategies and put all the funds money in one basket.

3.2.2 Market manipulation

The hedge fund managers may also test the limits of acceptable practice in relation to market manipulation. Some larger hedge funds have been suggested to be tempted to use their size, or start market rumours, to deliberately move the market and benefit from advantageous prices. The Market Abuse Directive regulates this area and the problem with market manipulation is not just to be found in relation to hedge fund activity⁵⁹.

⁵⁶ DP05/4 p. 34.

⁵⁷ Directive 2003/6/EC of the European Parliament and of the council of 28 January 2003 on insider dealing and market manipulation (The Market Abuse Directive).

⁵⁸ Humer, Caroline; “*Merger talk: Unusual trading surrounds biggest deals*”, Reuters Online, April 5, 2007.

https://secure.reuters.com/news/articleinvesting.aspx?type=mergersNews&storyID=2007-04-05T153945Z_01_N05184026_RTRIDST_0_COLUMN-MERGERS-SCHEDULED-WEEKLY-COLUMN.XML or <http://www.ft.com/cms/s/5e3da614-f112-11db-838b-000b5df10621.html>

⁵⁹ DP05/4 p. 53.

3.3 Risk to financial crime objectives

3.3.1 Fraud

Over the last few years, there have been several hedge fund scandals that has received public attention. Investors have lost considerable amounts of money due to these frauds and the SEC had pursued 51 such cases against U.S. based managers that had defrauded hedge fund investors or used the fund to defraud others up until 2005. Over a five-year period, the sum of money amounted to \$1.1 billion. As the funds have grown in popularity and the amount of funds has greatly increased, it is perhaps inevitable that fraudsters use hedge funds as a means to commit fraud. The two main types of frauds are fraudulent financial reporting, where the managers inflate returns⁶⁰, and the usage of Ponzi schemes⁶¹.

In the US, it is much easier to set up a hedge fund and therefore the cases of fraud have been more⁶². In the EU and the UK, hedge fund managers are more rigorously regulated and the UK market has not seen nearly as many frauds as the U.S.⁶³. In the UK, hedge fund managers are required to be authorised by the FSA and have to meet the FSA's requirements⁶⁴. The usage of independent fund administrators, which is a common practice in Europe, whose job it is to ensure that the fund's valuations comply with the regulatory requirements, can in part explain the small amount of fraud cases in Europe⁶⁵. One must also have in mind that the U.S. hedge fund industry is much bigger than the hedge fund industry found in Europe, which makes it slightly less surprising to find that there are more frauds committed in the U.S.

⁶⁰ The Manhattan Investment Fund in New York is a good example. In 2000, Michael Berger, a hedge fund adviser at Manhattan Investment Fund Ltd, was charged by the SEC for having inflated the fund's returns. Instead of declaring the funds actual losses from trading, he created false account statements. The SEC charged Berger who later fled the country.

⁶¹ A Ponzi scheme is a scheme where managers set up a pyramid using money from a set of investors who have entered the fund late to pay earlier investors. In the end, the last investors entering the fund will be the ones that will have to take the hit.

⁶² The SEC is now proposing increasing regulation in relation to hedge fund and frauds:

<http://www.sec.gov/rules/proposed/2006/33-8766.pdf>. Also:

<http://www.sec.gov/rules/proposed/ia-2266.htm> and

http://www.hedgeweek.com/articles/detail.jsp?content_id=42798

⁶³ DP05/4 p. 57. For further reading regarding US and UK frauds, see: Cantrell, "Hedge fund fraud much higher in U.S." *CNN Money* October 27, 2005, Cantrell, "Hedge fund has-beens" *CNN Money* July 11, 2005. For further reading regarding the US hedge fund regulation, please see: Hammer, Douglas; Haynes, Geoffrey; Reiser, Carolyn S: "U.S. Regulation of Hedge Funds", American Bar Association, 2005.

⁶⁴ Please see chapter 4.8 regarding the regulation concerning hedge fund managers.

⁶⁵ The alternative investment expert group's report to the European Commission, *Managing, servicing and marketing hedge funds in Europe*, July 2006.

3.3.2 Money laundering

As with any other fund, there is always the possibility of a fund being used for money laundering purposes. There are currently no indications that hedge funds are more widely used than other investment vehicles for laundering money⁶⁶. Hedge funds investing in Europe are subject to the anti money laundering directive and so are all other investment vehicles investing in Europe.

3.3.3 Closing remarks regarding risks

The national authorities and regulators throughout the world are dealing with these issues. Chapters 4-5 will describe the national and international regulations and efforts that are made to mitigate the risks associated with hedge funds from the view of investor protection and stability in the financial markets since these are the main risks.

We will see that the regulations that the hedge funds are subjected to are different from the regulation mutual funds are subjected to. We will also see that countries do not wish to lose a big financial industry such as the hedge fund industry by imposing too harsh rules as the hedge fund industry generates a lot of income for the governments. Let us also not forget that the reason for why there is an industry in the first place is that there is a demand for the hedge funds and their way of investing capital.

⁶⁶ DP05/4 p. 57.

4 Analysis of the national regulation & efforts on mitigating the risks

4.1 National risk mitigation – the UK

As the UK is the financial centre of Europe and London one of the major banking centres of the world, I will use the hedge fund regulation in the UK to provide the reader with an example of how risks are mitigated through national regulations. Many of the regulations in the UK are based on directives from the EU and the regulation can be described as somewhat similar throughout the union. However, there are significant differences between the EU members' legislation, which will be seen in the comparative chapter. In this chapter the focus is mainly on the mitigation of the risks posed to the individual investors. The mitigation of the potential risks posed to the financial system, systematic risk, is mainly discussed in chapter 5.

4.2 London as the financial centre in the EU

The headquarters of more than 100 of Europe's largest companies are located in London. However, it is not only the European companies that have chosen to have their main offices in London, a quarter of the world's largest financial companies have their European headquarters in London.

The foreign exchange market in London has a daily turnover of more than \$500 billion, which makes it the largest in the world, more than New York and Tokyo combined. There are more than 550 international banks in London, which can be contrasted by Frankfurt's 280, Paris' 270 and New York's 250. The capital also has the biggest market in the world for over-the-counter (OTC) derivatives with 36% of global turnover. London is the world's largest fund management centre. 56% of the global foreign equity market and 70% of Eurobonds are traded in London. London is further the world's largest international insurance market⁶⁷.

4.3 The FSA as a risk regulator

The Financial Services Authority (FSA) is an independent body set up by the government under the Financial Services and Markets Act 2000 (FSMA)

⁶⁷ Figures from the British government on: <http://www.london.gov.uk/london-life/business-and-jobs/financial-centre.jsp>. For more figures regarding London's share in international financial markets, please also see: <http://web.uflib.ufl.edu/cm/business/cases/london.htm>.

to regulate the financial services, retain the confidence in the financial system, and protect the rights of consumers and investors in the UK⁶⁸. The FSA thereby regulates the hedge fund industry within its jurisdiction, primarily the managing, prime broking and marketing issues relating to hedge fund activities. Before the FSA and the FSMA were created, the financial markets were regulated by the Bank of England but the UK also had, and to some extent still has, a great deal of self-regulation⁶⁹.

The authority's general duties and regulatory objectives are:

- Market confidence⁷⁰ – The market confidence objective means: maintaining confidence in the financial system⁷¹ in the United Kingdom⁷² and this includes any activities connected with financial markets and exchanges⁷³. A part of this objective is to mitigate the risks that investors face with regards to market confidence.
- Public awareness⁷⁴ - The public awareness objective is set out in section 4 of the FSMA and is defined as: “promoting public understanding of the financial system”⁷⁵.
- The protection of consumers⁷⁶ - The FSA shall secure the appropriate degree of protection for consumers and in considering what degree of protection may be appropriate, the FSA must have regard to matters such as risks, the consumer's lack of experience, the consumer's need for advice etc⁷⁷. It must be noted that there is also a general principle stipulating that consumers should take responsibility for their own decisions⁷⁸. All investors shall be protected against risks that may have an impact on the market confidence but consumers shall be protected in particular as they lack the experience professional investors possess.
- The reduction of financial crime⁷⁹ - The reduction of financial crime objective is: reducing the extent to which it is possible for a business carried on by a regulated person, or in contravention of the general prohibition, to be used for a purpose connected with financial crime⁸⁰. The term financial crime includes any

⁶⁸ For more information regarding the governance structure and approaches taken by financial regulators in the EU, please see Lastra, Maria; *The Governance Structure for Financial Regulation in Europe*, London: LSE Financial Markets Group, 2001.

⁶⁹ Pettet, *Company Law* (2nd ed., 2005) pp. 321-323.

⁷⁰ FSMA s. 2 (2)(a)

⁷¹ *Ibid* s. 3.

⁷² *Ibid* s. 3(2)

⁷³ *Ibid* s 3(2)(c)

⁷⁴ *Ibid*. ss. 2 (2)(b), 4.

⁷⁵ *Ibid*. 4(1)

⁷⁶ *Ibid*. ss. 2 (2)(c), 5.

⁷⁷ *Ibid*. s. 5(2).

⁷⁸ *Ibid*. 5(2)(d)

⁷⁹ *Ibid*. s. 2 (2)(d)

⁸⁰ *Ibid*. s 6(1).

offence involving fraud or dishonesty, misconduct in, or misuse of information relating to, a financial market; or handling the proceeds of crime⁸¹.

To be able to perform its duties, the FSA has through the FSMA, been given rule-making powers which can be found in Part 10 of the FSMA⁸². These FSA rules have the force of law and the authority will be capable of imposing binding obligations upon authorised persons⁸³. S. 138 of the FSMA enable the FSA to lay down different requirements, anywhere from broad principles to detailed rules. The FSA can also give waivers and display its rules on a case-by-case basis as stipulated in s. 148. S. 138 make it possible for the FSA to issue guidance on its regulations and rules. The guidance issued by the FSA is not legally binding though.

4.4 The FSA's general principles

The regulation in the UK is rather unique as it does not have to be detailed to be binding. The FSA can lay down principles and these principles must be adhered to. In the financial markets, there is a constant development of new products and an ad hoc approach to legislation would be inefficient and impede the security of the investors as complex products are put in the marketplace. Also, as the financial products become more and more advanced, it is perhaps better to let the experts at the FSA ensure that rules are upheld and that there is a strong market cleanliness. For example, through something called "side letters", some investors in the UK get a more favourable treatment from the hedge funds than normal investors. If not all investors in the fund are informed about the existence of side letters, the FSA has deemed the behaviour to be against the FSA's first general principle: "A firm must conduct its business with integrity"⁸⁴.

The chairman of the U.S. Federal Reserve, Ben Bernanke, is also in favour of implementing a principles based approach in the U.S.: "...we should strive to develop common, principles-based policy responses that can be applied consistently across the financial sector to meet clearly defined objectives"⁸⁵.

Anyone who is conducting business in the financial industry in the UK must adhere to FSA's general broad principles⁸⁶:

1 Integrity	A firm must conduct its business with integrity.
--------------------	--

⁸¹ *Ibid.* s. 6(3).

⁸² *Ibid.* ss. 138-156.

⁸³ For more information, see: Pettet, *Company Law* (2nd ed., 2005), pp. 346-348.

⁸⁴ The Financial Services Authority Feedback statement 06/2, 'Hedge funds: A discussion of risk and regulatory engagement - Feedback on DP05/4', 2006, p. 6.

⁸⁵ Grant, Jeremy: "Bernanke calls for UK-style regulation", *Financial Times*, May 15, 2007.

⁸⁶ See the FSA handbook on: <http://fsahandbook.info/FSA/html/handbook/PRIN/2/1>

2 Skill, care and diligence	A firm must conduct its business with due skill, care and diligence.
3 Management and control	A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4 Financial prudence	A firm must maintain adequate financial resources.
5 Market conduct	A firm must observe proper standards of market conduct.
6 Customers' interests	A firm must pay due regard to the interests of its customers and treat them fairly.
7 Communications with clients	A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8 Conflicts of interest	A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9 Customers: relationships of trust	A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
10 Clients' assets	A firm must arrange adequate protection for clients' assets when it is responsible for them.
11 Relations with regulators	A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

4.5 Regulated activities

Only authorised persons are allowed to perform regulated activities. "Authorised persons" are defined in s. 31. "Regulated activities" are defined in s. 22 and the section pretty much stipulates that if a person is in any way doing anything that has to do with investments as a way of business, it falls under the regime:

Section 22. - (1) An activity is a regulated activity for the purposes of this Act if it is an activity of a specified kind which is carried on by way of business and-

- (a) relates to an investment of a specified kind; or

- (b) in the case of an activity of a kind which is also specified for the purposes of this paragraph, is carried on in relation to property of any kind.
- (2) Schedule 2 makes provision supplementing this section.
- (3) Nothing in Schedule 2 limits the powers conferred by subsection (1).
- (4) "Investment" includes any asset, right or interest.
- (5) "Specified" means specified in an order made by the Treasury.

Managing or promoting a hedge fund in the UK falls under this regime and it is an offence to perform a regulated activity without being authorised, s. 23. More on this in chapters 4.7 and 4.8.

4.6 Collective investment schemes

Hedge funds can be either domiciled in the UK or abroad. A fund domiciled in the UK is registered and set up in the UK. If the fund is not set up in the UK but solely acting in the UK it is not a UK fund. Depending on how and where they are domiciled and which investment strategies they are using, different rules regarding their activities will apply while they are acting in the UK. In the UK the rules are different depending on whether the funds are considered to be regulated or unregulated Collective Investment Schemes (CISs). If they are unregulated, they are free to use any investment strategies they wish but in turn, they are not marketable to the public, which will be seen in chapter 4.7.

4.6.1 Hedge Funds Domiciled in the UK

Funds can be set up in several ways and are then most often considered to be CISs⁸⁷. The main fund structures in the UK are:

- Investment trust companies – not based on trust law despite the name. Investors buy and sell shares in the investment trust company through the stock market.
- Unit trusts – No corporate structures but trusts. The investors pool their capital and the fund is then held and invested by trustees, acting on the advice of expert fund managers⁸⁸.
- Open-Ended Investment Companies (OEICs).⁸⁹ - Recently allowed in the UK.⁹⁰ Using trusts as a way of running a fund aimed at normal investors is not very common in Europe so there is a need for OEICs for selling shares of a fund outside of the UK. The name comes from the feature that OEICs can easily issue shares to investors and buy

⁸⁷ The definition of the CIS is found in s. 235 FSMA.

⁸⁸ Trusts are interesting legal entities and in general, their regulation differs significantly from the regulation that applies to companies. To specifically analyse the trusts as legal entities however, is outside the scope of this thesis.

⁸⁹ s. 236 FSMA, also ss. 262, 263 FSMA.

⁹⁰ The formation of an OEIC was illegal until 1981 when the Companies Act that year permitted companies to purchase their own shares.

them back again, which for investment trust companies is much harder. In recent years, many unit trusts and investment trust companies has converted to OEICs for practical reasons⁹¹.

The regulation of CISs and OEICs is found in part XVII in the FSMA and under the Collective Investment Schemes rules in the FSA handbook⁹². The background to the OEICS provisions is found in the UCITS Directive⁹³, which tries to harmonise regulation for regulated CISs in the European Economic Community (EEC). Persons involved in running the funds must be authorised, otherwise they may be committing a criminal offence⁹⁴.

We will see that hedge funds never qualifies to be regulated CISs and are thereby not marketable to the public.

4.6.2 Hedge funds domiciled within the EU – UCITS

Undertakings for Collective Investment in Transferable Securities (UCITS) funds are invented by the EU to work as European funds. To become considered a UCITS fund, a fund is set up in one of the member states and, after qualification and authorization in that member state, given a passport so that it can be sold cross-border with minimum intervention by national regulators in the 'host' state. A fund authorised as a UCITS fund in the EU is automatically considered a regulated CIS in the UK through FSMA s. 31 (1)(d).

A UCITS fund cannot invest its assets however it pleases, just like regulated CISs in the UK⁹⁵. The directive establishes which assets are qualified for investment by a UCITS fund⁹⁶. An authorised fund that aims for absolute returns, just like a hedge fund, is now possible because of liberalisations under UCITS III.⁹⁷ The funds can now use derivatives for investment purposes, short selling and leveraging up to 100% of the net asset value of the fund using derivatives but not debt leverage. Before these changes, UCITS schemes were allowed to invest in derivatives only and then solely for the purposes of efficient portfolio management, to reduce risk, reduce cost or generate income for the fund with an acceptably low level of risk, not to try to increase the profits directly⁹⁸. The manager must still comply with restrictions such as that no more than 10% of the net asset value is

⁹¹ For more information about CISs, see: Pettet, *Company Law* (2nd ed., 2005), pp. 351-353.

⁹² <http://fsahandbook.info/FSA/html/handbook/COLL>

⁹³ Undertakings for Collective Investment in Transferable Securities (UCITS) funds Directive 85/611/EEC.

⁹⁴ s. 19 FSMA and Art. 51 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 SI 2001 No. 544.

⁹⁵ The regulation regarding what a regulated CIS can invest in is based on the UCITS directives.

⁹⁶ Article 19(1) of the UCITS Directive.

⁹⁷ Directives 2001/107/EC and 2001/108/EC, implemented in the UK through the FSA's Collective Investment Schemes Sourcebook (COLL) when it was introduced in April 2004.

⁹⁸ For more information regarding UCITS, please see:
http://www.efama.org/20Regulation/20Lawsreg/UCITS_Dir_Upd/

invested in any single security⁹⁹. Funds of hedge funds, i.e. funds that invest in hedge funds, are not permitted according to the provisions in the directive and that has caused some debate. In the next chapter, we will see that a fund that qualifies as a UCITS fund, which is very often a mutual fund, is marketable to the public.

There are currently no indications that the hedge fund industry is widely using the new opportunity to start UCITS hedge funds in the EU in order to be marketable¹⁰⁰. Even though UCITS III gives the managers of a UCITS fund more freedom in investing the funds assets, offshore hedge funds has total freedom and can change their risk exposure and strategy instantly if they wish and they do not have to pay tax. The UCITS directives cannot give offshore funds more flexibility. The rules will be more welcomed by traditional funds than hedge funds.

4.7 The marketing of hedge funds in the UK

One way of mitigating the risk the hedge funds constitutes to the public is to reduce their marketability. The marketing of CISs, domiciled in the UK or not, is regulated in s. 238 FSMA. Under section 238 of the FSMA (Restrictions on promotion), only certain kinds of collective investment schemes may be promoted to the public by authorised persons. These are:

- (1) Authorised funds constituted in the United Kingdom; and
- (2) Collective investment schemes constituted outside the United Kingdom and recognised by the FSA under:
 - a) Section 264 of the Act (Schemes constituted in other EEA States) - these are schemes that qualify under the UCITS Directive;
 - b) Section 270 of the Act (Schemes authorised in designated countries or territories); and
 - c) Section 272 of the Act (Individually recognised overseas schemes).

To get authorisation/recognition, the CISs must comply with detailed rules, and among these rules are the rules about risk spreading which the hedge funds rarely can comply with due to their investment strategies¹⁰¹. It does not matter if the fund is domiciled in the UK or not¹⁰². If the CIS fails to comply with the FSA rules regarding the risk spreading rules set out in COLL 5 of the FSA's handbook, it will be considered an unregulated CIS and is then not marketable to the public¹⁰³.

⁹⁹ Art. 19(1)(e) of the UCITS Directive.

¹⁰⁰ DP05/3 p. 16.

¹⁰¹ The UCITS Directive 85/611/EEC and its amendments, Directives 2001/108/EC and 2001/107/EC regulates in article 19(1) of the directive the allowed risk exposure. See also the COLL Chapter 5 for the FSA's implementation of Article 19(1).

¹⁰² ss. 19, 21 FSMA.

¹⁰³ s. 238 FSMA and COLL 5.3.

Unregulated CISs funds may only be marketed to intermediate customers or market counterparties, or to private customers for whom the authorised firm considers the investment suitable¹⁰⁴. It is the responsibility of the firm to undertake due diligence to determine suitability. As a consequence, only mutual funds can be marketed to the general public. The ability for hedge funds to be marketed to retail investors is restricted, but not ultimately excluded. This is how the risk to consumers and less experienced investors is mitigated. Investors wishing to invest in a hedge fund can still find the funds themselves though.

Since the tax regime often is more favourable offshore, marketing issues are not the funds main concerns when they choose to not be domiciled in the UK. The investors the funds are trying to attract are often active investors and institutions with large amounts of assets, not the general public. The funds are therefore not in need of being able to be marketed to the public, nor do they wish the public to invest in the funds since they mostly have requirements of large minimal investments¹⁰⁵. The risk for consumers under the present legislation is therefore small and the FSA does not intend to increase the rules.

Another aspect of hedge funds not being permitted to be marketed to the public is that the public has less investment opportunities. If a person has less investment opportunities, it is harder for that person to spread his risk. So, by actually preventing the public to have easy access to hedge funds, the risk for a normal person can be argued to be higher than it otherwise would have been. One must keep in mind though, that consumers can still invest in hedge funds but they will have to find them by themselves.

4.8 Regulation of hedge fund managers

To avoid the risk of funds failing due to unprofessional mistakes based on incompetence, UK hedge fund managers are required to be authorised by the FSA according to s. 19 FSMA, article 37 (Managing Investments) and article 53 (Advising on investments) of The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 SI 2001 No. 544. Authorised managers are firms and not individuals, they are required to achieve and maintain the threshold conditions for authorisation as stated in the FSMA¹⁰⁶. In consideration of an application for authorisation of a hedge fund manager, the FSA will pay particular attention on the resources and competence to manage the assets of the funds in accordance with the mandates from the operators of the underlying fund. The appropriateness of information feeds for pricing and other market information, the capability of the internal systems and controls, and the compliance with UK regulations.

¹⁰⁴ They can be marketed as set out in Annex 5 to Chapter 3 of the FSA's Conduct of Business Sourcebook.

¹⁰⁵ Requirements are often not less than £50,000 according to DP05/3 p. 16.

¹⁰⁶ s. 41 FSMA.

The FSA has been given the power to make a ‘prohibition order’ against any person that it considers not fit and proper to perform a type of function in carrying out certain regulated activities¹⁰⁷.

Managers must follow the rules in the FSA’s Senior Management Arrangement, Systems and Controls Sourcebook (SYSC)¹⁰⁸. The manager must take reasonable care to establish and maintain such systems and controls as are appropriate to its business¹⁰⁹. This includes rules regarding: general organisational requirements; employees; compliance; risk control; outsourcing; record keeping and conflicts of interest. If a firm fails to meet the standard set out in the SYSC it is in breach of FSA’s rules. For example, if a hedge fund manager chooses to invest the funds money in a company he is an owner of it is a clear breach to the FSA’s rules regarding conflict of interest.

4.8.1 The Conduct of Business rules

A person running a hedge fund in the UK must comply with the FSA’s general principles found above but also with the FSA’s Handbook of Rules and Guidance and in particular the parts; Principles for Business rules and the Conduct of Business (COB) rules.

The FSA's Conduct of Business rules for investment business have been in operation since the FSA took on its regulatory responsibilities in December 2001. The rules cover, among other things: financial promotions, how firms provide information and advice to clients, non-advised services, and dealing in and managing investments¹¹⁰. The FSA is currently reforming the COB in a move towards a more principle-based regulation and away from detailed prescriptive rules. The FSA wishes to remove around half the content of the old rulebook with the end result being a new COB, the NEWCOB. The FSA is carrying this forward at the same time as it is implementing the relevant provisions of the Market in Financial Instruments Directive (MiFID)¹¹¹.

4.8.2 The Market in Financial Instruments Directive (MiFID)

The MiFID¹¹² directive will introduce a single market and regulatory regime for investment services across the 30 member states of the European

¹⁰⁷ ss. 56-58 FSMA. Authorised firms can not employ these prohibited persons.

¹⁰⁸ This systems and controls regulation is a part of Basel II which will be further discussed in chapters 5.1.3 – 5.1.4.

¹⁰⁹ The FSA Handbook: SYSC 3.1.1R. For full text:

<http://fsahandbook.info/FSA/html/handbook/SYSC>

¹¹⁰ <http://fsahandbook.info/FSA/html/handbook/COB>

¹¹¹ Details of the proposed NEWCOB are set out in the FSA’s Consultation Paper 06/19 “Reforming Conducts of Business Regulation”, October, 2006, and the FSA’s Consultation Paper 06/20 “Financial Promotion and other communications”, October, 2006.

¹¹² Directive 2004/39/EC

Economic Area (the 27 Member States of the European Union plus Iceland, Norway and Liechtenstein). There are 3 objectives to be met by the Directive. First, to complete the process of creating a single EU market for investment services. Second, to respond to changes and innovations which have occurred in securities markets. Third, to protect investors by making markets deeper, more competitive and more robust against fraud and abuse. It will replace the Investment Services Directive¹¹³. MiFID is the cornerstone of the European Commission's Financial Services Action Plan whose 42 measures will significantly change how EU financial service markets operate. MiFID is the most significant piece of legislation introduced under the 'Lamfalussy' procedure designed to accelerate the adopting of legislation based on a four-level approach recommended by the Committee of Wise Men chaired by Baron Alexandre Lamfalussy. As of June, 2006 there are three other 'Lamfalussy Directives' - the Prospectus Directive¹¹⁴, the Market Abuse Directive¹¹⁵ and the Transparency Directive¹¹⁶.

Hedge Funds selling shares in the fund in the UK, often through the hedge fund managers, will be affected by the MiFID rules regarding investment advice. The MiFID Directive includes in Article 19(6) a segregation of products into 'complex' and 'non-complex'. Under MiFID, only non-complex products can be sold on an execution-only basis (i.e. without advice or any form of test to indicate the appropriateness of the investment for the consumer). The sale of a complex product will require the seller to determine at least the appropriateness of the product for the consumer.

Where advice is given to the consumer, the higher standard for an advised sale will apply. In the UK these rules will be found in the NEWCOB. The FSA aims to favour principles and high-level rules except for where detailed provisions are either required by EU directives or found necessary. The NEWCOB will replace the COB from 1 November 2007, the same time as MiFID comes into general effect across the UK and the European Union¹¹⁷.

The Directive itself establishes that in general, shares admitted to trading on a regulated market, money market instruments, bonds and other forms of securitised debt, and all UCITS, are non-complex instruments. Hence, MiFID operates on the assumption that investment products that take the form of, for example, shares or UCITS can be sold cross-border on an execution-only basis, without advice or a test of appropriateness. As stated earlier, hedge funds and funds of hedge funds are not UCITS and are thereby viewed as complex instruments. A person trying to sell shares in a hedge fund must take precaution and determine the appropriateness of the product for the consumer.

¹¹³ Directive 93/22/EEC

¹¹⁴ Directive 2003/71/EC

¹¹⁵ Directive 2003/6/EC

¹¹⁶ Directive 2004/109/EC

¹¹⁷ FSA press release: FSA/PN109/2006, 31 October 2006.

As can be seen, the consumer is protected by law. Mutual funds qualifies as UCITS and can not only be sold cross bordered in the EU but also much easier as they are not deemed to be complex instruments. Hedge funds must not only file with the financial authorities in every EC country they wish to be sold in, they must also be aware and take precaution of how they are marketed and sold.

As the promoting of hedge funds is not made easy there might be a risk that consumers will not use them as a way of diversifying their portfolios and managing risks. After all, hedge funds have, in general, produced outstanding results in the past and I question if it is really in the best interest of the consumer and the non-professional investors to only have easy access to mutual funds.

4.8.3 The supervision of hedge fund managers

The supervision of hedge fund managers once authorised is not intensive. This is due to the fact that nearly all of them are regarded as to attract a low impact or risk rating under the FSA's current risk assessment approach¹¹⁸ and are therefore not subject to extensive supervision¹¹⁹. As the administration and keeping of the fund is typically based offshore, many of these managers only have one customer, which is the offshore administrator of the hedge fund or the hedge fund itself. This further reduces the impact of the UK-authorized firm. The nature of the hedge funds and the not always so clear valuations of the different assets a hedge fund can possess do not reduce the risk of false valuations and fraud by the management. These risks more often affects the investor in the hedge fund than the system itself and considering that the funds are not regulated CISs and thereby not marketable to the public, there are not strong incentives for the regulator to impose stricter rules than already exists¹²⁰. The FSA recommends and emphasises the importance of the investors to carry out proper due diligence before investing in a fund to reduce their risk¹²¹.

The FSA's rules only relates to the controls and systems that the manager of the fund uses, not the strategies. A fund can use a trading strategy that makes the fund become insolvent over a night without being in breach of FSA's rules. The fund is the legal person that carries out all the funds business. Therefore, the requirement for the hedge fund manager to have adequate systems and controls does not imply that either the hedge fund manager or the FSA have oversight of the systems and controls of the

¹¹⁸ See note 31 and McCarthy, "Risk based regulation: the FSA experience" Speech, February 13, 2006 on

http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0213_cm.shtml

For more information regarding the FSA's risk assessment framework, please see: the FSA's: "The FSA's Assessment framework", August, 2006.

¹¹⁹ DP05/4 p. 17.

¹²⁰ Unless they are large funds and highly leveraged in which case their default can affect the financial system, see chapter 5.1.

¹²¹ The Financial Services Authority Feedback statement 06/2, '*Hedge funds: A discussion of risk and regulatory engagement - Feedback on DP05/4*', 2006. (FS06/2). p. 24.

underlying hedge fund. In FS06/2¹²² the FSA announced that it did not propose to take forward work on the option of creating a hedge fund management permission specifically designed for hedge fund managers. One reason for this is that it would mean that the FSA would have to define what a hedge fund is which is not easily done and has not been done in other jurisdictions. More rules could also mean that managers would chose to be domiciled elsewhere and the rules would not be efficient anyway since they would still not apply to the fund, only the manager¹²³. If stricter rules were imposed and managers moved, then the funds would still be investing on the UK markets but the FSA would have no insight in the funds business at all which is not a better alternative. The risks can not be mitigated directly by the FSA imposing rules on the management only. There are jurisdictional issues here.

Hedge funds often try to attract institutional investors and as the institutional investors manage a lot of money, they can protect themselves by requiring the funds to implement efficient systems and controls. Consumers can not use their size to protect themselves which is why it might be appropriate to have rules that makes it harder for consumers to access the funds.

4.8.4 Funds of hedge funds

Even though there might be a good idea to prevent consumers and non-professional investors to have easy access to single hedge funds, it should perhaps not be as hard to access funds that invest in hedge funds; “fund of hedge funds”. Such a fund would be considered to be a regulated fund that invests in unregulated funds and that would give the consumer a possibility to have easy access to hedge fund strategies without having to face the fund specific risks. The form of consumer protection for such a fund would not have to involve any substantial constraint on the investment strategy that the managers of the underlying hedge funds can pursue. Instead the regulation could concentrate on structural questions such as the functional separation between the manager of the fund and custodian, or the pricing of the fund, and the manager of the regulated fund could for example be obliged to carry out due diligence in the funds the regulated fund invested in. A fund of hedge funds, easy accessible by retail investors, is welcomed by the FSA and the FSA is currently consulting on plans to introduce such a fund¹²⁴.

¹²² The Financial Services Authority Feedback statement 06/2, ‘*Hedge funds: A discussion of risk and regulatory engagement - Feedback on DP05/4*’, 2006.

¹²³ FS06/2 p. 15.

¹²⁴ The Financial Services Authority’s Consultation Paper 07/6, ‘*Funds of Alternative Investment Funds*’. March, 2007.

4.9 Financial Services Compensation Scheme (FSCS)

Another way of mitigating the risk of fraud, incorrect valuation etc faced by investors is to guarantee the capital invested if a fraud is committed or assets inaccurately valued. The FSCS can pay compensation if a financial firm is unable to pay claims against it. The FSCS is an independent body set up by law and is funded by levies paid by all firms authorised by the FSA. The funding rules can be found in the FSA's Handbook under the COMP 13 rules. The legislator has thereby tried to mitigate the risks for consumers if a fund should fail for some reason. One effect of the fund not being an authorised CIS is that in the event of a hedge fund becoming insolvent; investors are then not likely to successfully claim under the scheme as only investors in regulated CIS are protected¹²⁵. The manager has undertaken to provide fund management services to the offshore hedge fund, not the investors in the fund and so claimants will have to establish that the manager owed them a duty of care, as underlying investors, if the investors wants to be compensated for any reason.

Only investors in mutual funds are protected through the FSCS. The scheme can pay compensation only for financial loss and there are limits to the amounts of compensation the FSCS can pay¹²⁶. Considering the fact that many hedge funds demands minimum investments of £50,000¹²⁷, which is more than what the FSCS covers, many investors would not be much better protected by the FSCS even if they placed their money in a UK domiciled or recognized hedge fund. However, if fund of hedge funds were to be considered as regulated CISs, investors would be protected in the unlikely event of a failure.

¹²⁵ It was created under the FSMA s. 212. For more information, see <http://www.fscs.org.uk/>

¹²⁶ See limits on:

www.fscs.org.uk/consumer/key_facts/limitations_of_the_scheme/compensation_limits/

¹²⁷ DP05/3 p. 16.

5 Analysis of the European and the international scope of the efforts of risk mitigation

As said in the chapter regarding risk: a fund that fails normally does not affect many more people than the investors. However, very large hedge funds, or a cluster of mid-sized funds, that are highly leveraged can have a major impact on the financial markets if they fail, especially on counterparties. A Failure will affect both the liquidity on the markets and the market confidence, investors might rush to withdraw their investments from the funds, and that would affect the financial stability. A drop in prices could cause more hedge funds to fail and the effect could ‘echo’ throughout the financial system. The near fall of LTCM, described in chapter 3.1.1, illustrates the potential scenario very well. Such an event would not only affect the individual investor but anyone who has capital placed in the financial markets: i.e. everyone. Both the ECB and the Federal Reserve of New York have expressed this fear of correlated behaviour in articles and publications¹²⁸.

For a fund to survive it must keep track of its risk exposures, which makes risk management essential in the sector. Funds using a large combination of strategies can find it hard to develop a well working risk model to stress test the fund with¹²⁹. The increasing incidence of multiple prime brokerage relationships and multiple trading relationships means that there may be cases where credit providers do not have an accurate picture of the risk profile of the fund.¹³⁰

The issues regarding financial stability and market confidence are international. Financial stability risks are likely to affect firms and markets in more than one jurisdiction. These kinds of risks are best mitigated through regulatory action that is co-ordinated globally and are therefore often dealt with in international forums, which will be seen.

¹²⁸ The ECB’s Financial Stability Review, June 2006, p 142. and Adrian T., Measuring risk in the hedge fund sector, *Current Issues* Volume 13, Number 3 March/April 2007 Federal Reserve Bank of New York.

¹²⁹ For a separate discussion about stress testing, see The FSA’s Discussion paper 05/2, ‘*Stress testing*’, 2005.

¹³⁰ DP05/4 pp. 17-22.

5.1 Financial stability and market confidence - systematic risk

5.1.1 The Financial Stability Forum (FSF)

In 1999, the G7 finance ministers set up the FSF to deal with the financial stability issues on a global level¹³¹. The Forum includes finance ministries, central banks and leading regulators from the G7 countries, the IMF, the World Bank, the regulators IOSCO and the Basel Committee etc. The Forum has two missions: first; to spot financial crises before they get to big and second; to resolve problems that might pose some threat to financial stability¹³².

One of the FSF first concerns was the near collapse of the fund Long Term Capital Management (LTCM) that in 1998 at one stage had a leverage ratio of over 50 to 1¹³³. The second concern that was identified was the spill over effects from the 1997/8 crises in Asia and Russia, when the authorities in some small and medium-sized open economies were concerned that HLIs had exerted a destabilising impact on their markets. The problem and risks the FSF identified was high leveraging, particularly in the hedge fund sector. Mutual funds cannot use as much leverage and therefore they do not pose a threat to the financial system. Before 1998 and LTCM, the leverage was not seen as a problem and the hedge fund sector was not very big. Today there has been a massive growth in the hedge fund sector and the leverage has therefore increased which can be seen in charts 1, 10 and 13 in Supplement A.

5.1.2 Highly leveraged institutions (HLIs)

The FSF established a working group to examine the HLIs who predominantly are hedge funds. The working group proposed in the year 2000 a number of recommendations on how to mitigate the risks¹³⁴, such as:

- Stronger counterparty risk management;
All counterparties to HLIs should review their counterparty risk management arrangements against the recommendations suggested by the Basel Committee¹³⁵.
- Stronger risk management by hedge funds;

¹³¹ For more information and background, see: www.fsforum.org/about/who_we_are.html

¹³² www.fsforum.org/about/what_we_do.html.

¹³³ Testimony of Richard R. Lindsey, Director SEC Division of Market Regulation before the House Committee on Banking and Financial Services, Concerning Hedge Fund Activities in the U.S. Financial Markets:

www.sec.gov/news/testimony/testarchive/1998/tsty1498.htm, as cited in DP05/4 p. 22.

¹³⁴ The FSF's 'Report of the Working Group on Highly Leveraged Institutions' (Report 1), 2000, p. 5. on: www.fsforum.org/publications/Rep_WG_HLI00.pdf

¹³⁵ Report 1 p. 6. For information about the Basel committee, see chapter 5.1.3.

Practices for risk management, internal controls, disclosure, transparency and documentation within the funds should be better and that there was an increased informal dialogue with market authorities.¹³⁶

- Enhanced regulatory oversight of HLI credit providers; Supervisors and regulators should take appropriate steps to verify the level of compliance with the Sound Practices rules created by the Basel Committee. The FSF suggested greater use of the supervisory review process of the ‘Pillar II’ of the Basel proposals and making it harder for firms to carry on business with HLIs where they consider that firm’s risk management practices to be poor¹³⁷.
- Enhanced public disclosure by HLIs in all jurisdictions¹³⁸.

5.1.3 The Basel Committee on Banking Supervision (The Committee) and Basel II - indirect regulation

As can be seen when studying the FSF’s recommendations; the major part of the recommendations is to make sure that national authorities overview how the hedge fund counterparties, primarily prime brokers, comply with rules promulgated by the Basel committee regarding risk. To indirectly monitor hedge funds through banking supervision is a way forward as almost everything hedge funds do is done via counterparties such as big investment banks. Andrew Crocket expresses a view that the funds cannot affect the systematic stability if their relationship with their counterparties, the banks, does not allow them to¹³⁹.

The central bank governors of the most economically influential countries created the Committee in 1974. Its membership is now composed of senior representatives of bank supervisory authorities and central banks from the G-10 countries and representatives from Luxemburg and Spain. The Basel Committee formulates broad supervisory standards and guidelines and recommends statements of best practice in banking supervision, such as the Basel II. The member authorities and other nation's authorities will then take steps to implement the committee’s recommendations through their own national systems, whether in statutory form or otherwise. The purpose of the committee is to encourage convergence toward common standards and approaches¹⁴⁰.

Basel II was created by the Committee to promote consistency in the way banks and banking regulators approach risk management across national

¹³⁶ Report 1 p. 6.

¹³⁷ Report 1 pp. 6, 7. For information about the Basel committee, see chapter 5.1.3.

¹³⁸ Report 1 p. 7.

¹³⁹ Crockett, A: ‘*The evolution and regulation of hedge funds*’ Financial Stability Review, edited by Banque de France, Special issue on hedge funds, April, 2007.

¹⁴⁰ For more info: See the Bank for International Settlements’ homepage on: www.bis.org/bcbs/history.htm

borders¹⁴¹. The framework aims to strengthen the soundness and stability of the international banking system. Among those affected by the rules are the financial regulators throughout the EU and the prime brokers that are counterparties to hedge funds. Basel II is an updated version of Basel I and uses a "three pillars" concept to promote greater stability in the financial system. They are:

- (1) Minimum capital requirements; the first pillar deals with risk sensitivity in the way that capital requirements are calculated in three of the components of risk that a bank (hedge fund counterparties) faces: credit-, operational- and market risk.
- (2) supervisory review; the second pillar regards the regulatory response to the first pillar and gives regulators 'tools' to assure compliance with pillar one. It also provides a regulatory framework for dealing with all the other risks that a bank faces combined under the title of residual risk.
- (3) Market discipline; this pillar greatly increases the disclosures that the bank must make and is intended to give the market a better picture of the overall risk position of the bank.

The FSF proposals regarding the over viewing of the compliance with regulation has led to initiatives at national level in the UK by the FSA and is primarily discussed in DP05/4 and in the feedback paper to the same discussion paper¹⁴². The FSA seeks to ensure that, following Basel guidelines, credit providers to hedge funds follow appropriate risk management practices¹⁴³. The risks arising from the prime broker's transactions with the funds are assessed as part of the FSA's risk-based assessment of the individual prime brokers¹⁴⁴. The FSA has established continuous relationships with the prime broker community through supervisors that oversees their activities as counterparties to hedge funds¹⁴⁵.

5.1.4 The Capital Requirements Directive (CRD)

As stipulated earlier, no sovereign country is directly legally bound to follow the Basel II rules. The framework has, however, been adopted in the EU by the creation of the Capital Requirement Directive which must be implemented by the EU countries. The Capital Requirements Directive,

¹⁴¹ The Basel Committee on Banking Supervision, '*Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework*', 2005. See <http://www.bis.org/publ/bcbs118.pdf>

¹⁴² FS06/2, see http://www.fsa.gov.uk/pubs/discussion/fs06_02.pdf

¹⁴³ See The Basel Committee on Banking Supervision, '*Sound Practices for Banks Interactions with Highly Leveraged Institutions*', 1999, the IOSCO/Basel Committees, '*Review of Issues Relating to Highly Leveraged Institutions*', 2001, and:

http://www.fsforum.org/compendium/compendium_of_standards_issuing_body_14.html
¹⁴⁴ FS06/2 p. 7.

¹⁴⁵ The FSA is also working with The London Investment Banking Association (LIBA) on conducting its regular six monthly survey of prime brokers' exposures to hedge funds, see: FS06/2 p. 7.

comprising Directive 2006/48/EC¹⁴⁶ and Directive 2006/49/EC¹⁴⁷, was published in the Official Journal on Friday 30 June 2006. The predecessor to the CRD was the Capital Adequacy Directive¹⁴⁸. The CRD will directly affect banks (counterparties) and building societies and certain types of investment firms. It has been implemented in the UK by new prudential regulations (GENPRU and BIPRU¹⁴⁹) covering capital resource requirements, credit risk, operational risk, market risk, group risk, valuation, securitisation, concentration, liquidity risk and disclosure.

The CRD and the rules implemented in the GENPRU and BIPRU will solely directly affect hedge funds domiciled in the UK and especially UCITS funds. However, by regulating the counterparties risk exposures, the risks to the financial system is better mitigated as the funds will find it harder to achieve high leveraging. Today it would be a direct breach of the Basel II and the CRD rules for a bank to provide a fund leveraged 50 to 1 like LTCM with credit¹⁵⁰. The prime broker should know about the funds risk position. Since the near collapse of LCTM, there are indications that the large and highly leveraged global macro funds has shut down and the amount of leveraging has also decreased.

Even if there might not be an immediate risk from banks in the EU providing the funds with credits, the funds can still borrow money etc from other legal entities both outside and inside of the EU or elsewhere, that are not covered by the Basel II or CRD rules. To fully prevent hedge funds from gearing up is with the present regulation impossible, as there is a jurisdictional problem involved. The potential risk remains and the FSF, The Committee, IOSCO and other organisations are constantly researching into the area and publish their findings and recommendations.

5.1.5 The public disclosure

The FSF's disclosure proposals are hard to implement because it is up to each country that hosts funds to decide whether they wish to impose rules. The hedge funds have not been very keen on disclosing their businesses since this would make them reveal their investment strategies, which could then easily be copied by other funds. Since the funds are domiciled offshore, they cannot be forced to disclose their activities and strategies, national authorities can only issue recommendations and the rules regarding valuations found in the FSA's BIPRU rules hardly affects offshore funds¹⁵¹.

¹⁴⁶ Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions.

¹⁴⁷ Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions.

¹⁴⁸ Directive 93/6/EEC

¹⁴⁹ See the FSA's Handbook regarding these rules;

<http://fsahandbook.info/FSA/html/handbook/D166>

¹⁵⁰ Especially the rules regarding "Large Exposures" in Articles 106 – 119 in Directive 2006/48/EC, the rules regarding "Provisions against risk" in Articles 18 – 21 in Directive 2006/49/EC.

¹⁵¹ See more in DP05/4 p. 25.

The increased interest for hedge funds by institutional investors and their demand for more disclosure have improved the transparency of some hedge funds but have not yet made them disclose all their business. Some other initiatives regarding disclosures have been made but there are still no requirements for hedge funds to disclose their activities even if there is an international interest¹⁵². A move by national regulators or the EU to demand the managers to disclose their strategies would probably make the managers choose other domiciles than countries within the EU to run their business from and in.

Again, we see that the funds can use regulative arbitrage to avoid inconveniences. As long as there is no international consensus the risk can not properly be mitigated. Disclosing would really help reducing risk and legislators know this. However, as a lot of income is derived from the hedge fund industry, no legislator wishes the industry to move to another jurisdiction. After all, there has not yet been a wide crash in the industry and screaming “wolf” and legislate would be detrimental to any country doing so.

5.1.6 Valuation risk mitigation

Typically, the valuation of hedge funds assets is sought from third party administrators who are often based offshore outside of UK jurisdiction¹⁵³. Many hedge funds invest in illiquid or complex contract based assets such as contracts for differences (CFDs) and credit derivatives for which there are no public benchmark prices. Administrators who are performing the valuation of illiquid or complex assets are forced to rely upon a combination of ways to value the assets like; counterparty quotes, valuation models,¹⁵⁴ and direct valuations from the hedge fund manager. As can be seen, there are questions about how independent these valuations actually are and the risk for false valuation is particularly significant where the actual trader, rather than an independent back office function, does the valuation¹⁵⁵. Administrators usually accept the hedge fund manager’s own valuations regarding assets for which there are no easy or robust valuation models. It is not hard to see that there can easily be a conflict of interest here since the manager’s remuneration most often is based on the funds performance.

To mitigate the risk of false valuation the funds sometimes use external auditors to review the models. Valuation is seen as a technical and complex area and regulation is difficult to impose considering that valuation

¹⁵² The Financial Stability Forum report, ‘*The FSF Recommendations and Concerns Raised by Highly Leveraged Institutions (HLIs): An Assessment*’, 2002, p. 6, also FS06/2 p. 24.

¹⁵³ There are no legal rules demanding funds to outsource the valuation from the fund itself. Unlike the situation for regulated CISs, Hedge funds are not required to have independent depositaries or trustees whose role is to ensure that the funds’ assets are valued in line with regulatory rules, See the FSA’s Handbook for detailed rules.

¹⁵⁴ Often developed by the hedge fund manager itself.

¹⁵⁵ DP05/4 pp. 50-52

oversight is in the end the responsibility of the fund's board which is most often domiciled where the board pleases; offshore¹⁵⁶. The CRD rules regarding valuations implemented in the UK in the GENPRU rules do not have any effect on offshore hedge funds. Currently, the investors and especially the rise of institutional investors investments in hedge funds, has secured independent valuation methods through agreements between the parties¹⁵⁷. Here again we see a jurisdictional problem and hedge funds can use regulatory arbitrage. As national legislators cannot do much about the problem it is up to, and in the interest of, the professional investors investing in the funds to really secure a satisfying accounting and valuation standard in order to mitigate this risk.

5.2 The Market Abuse Directive

The implementation of the Market Abuse Directive (MAD) resulted in an EU-wide market abuse regime. The MAD is a part of the Lamfalussy process as stated earlier. The MAD defines what behaviour will be considered as market abuse, namely insider dealing¹⁵⁸ and market manipulation¹⁵⁹. The MAD applies to any financial instrument admitted to trading on a regulated market, or those where a request for admission to trading has been made.

Article 2(1) stipulates that: "Member States shall prohibit any person referred to in the second subparagraph who possesses inside information from using that information by acquiring or disposing of, or by trying to acquire or dispose of, for his own account or for the account of a third party, either directly or indirectly, financial instruments to which that information relates". Article 4 stipulates that: "Member States shall ensure that Articles 2 and 3 also apply to any person, other than the persons referred to in those Articles, who possesses inside information while that person knows, or ought to have known, that it is inside information". Hence, Insider dealing is forbidden for anyone who is trading on regulated markets within the EU, also for hedge funds domiciled offshore.

Article 5 stipulates that: "Member States shall prohibit any person from engaging in market manipulation". Funds can therefore not engage in any activity aimed to manipulate markets within the EU.

Here, it is of no direct interest if a fund is domiciled in an offshore jurisdiction. If a financial instrument is bought on a regulated market within the EU, the regulation applies. In theory, the risk of market abuse is mitigated. The problem with insider dealings relates more to the possibilities of trading anonymously on the markets, and that can be done via EU countries such as Luxemburg for example. In addition, the rapid growth of

¹⁵⁶ FS06/2 p. 26

¹⁵⁷ DP05/4 pp. 47-48.

¹⁵⁸ Directive 2003/6/EC Article 1(1)

¹⁵⁹ *Ibid* Article 1(2)

over-the-counter traded derivatives such as contracts for differences (CFDs) and credit default swaps (CDSs) has perhaps moved the insider dealers from the open exchanges to the backrooms of the financial institutions.

5.3 The Money Laundering Directive

This risk to the financial crime objective is mitigated in the EU through this directive. On the 7th June 2005 the Directive of the European Parliament and of the Council on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing (the Third EC Money Laundering Directive) reached political agreement¹⁶⁰. Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with the directive by 15 December 2007¹⁶¹.

The first Money Laundering Directive of 1991¹⁶² required the obligation of a duty on financial institutions to establish customers' identity and report any suspicion of money laundering.

The second directive of 2001¹⁶³ extended the number of crimes to which the provisions applied and widened the range of professions who had to observe it to include lawyers, auditors, accountants, notaries, casinos and estate agents. It also provided for the establishment of financial intelligence units in each member state to which suspicious transactions reports (SRTs) were to be made.

The third directive will incorporate into EU law revisions made and it will also extend the provisions to any financial transaction which might be linked to terrorist activities. Further provisions are:

- identity checks on customers opening accounts (i.e. accounts cannot be held anonymously)¹⁶⁴;
- checks apply to any transaction over €15,000¹⁶⁵;
- stricter checks on 'politically exposed persons' (those in responsible public positions and their families)¹⁶⁶;
- penalties for failure to report suspicious transactions to national financial intelligence units¹⁶⁷.

As can be seen, it does not matter if a hedge fund is domiciled in the EU or not. The anti money laundering provisions covers any activity by the fund, a

¹⁶⁰ Directive 2005/60/EC of the European parliament and of the council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing.

¹⁶¹ Directive 2005/60/EC Article 45.

¹⁶² Directive 91/308/EEC

¹⁶³ Directive 2001/97/EC.

¹⁶⁴ Directive 2005/60/EC Article 6.

¹⁶⁵ *Ibid* Article 7(b)

¹⁶⁶ *Ibid* Article 13(4)

¹⁶⁷ *Ibid* Articles 20 – 21.

person representing the fund or any other person facilitating the laundering of money for the fund in the EU. Here, if “unclean” money reaches the EU, the provisions apply. The risk is, in my opinion, mitigated through this directive, at least in theory.

6 Comparative outlook

In Europe, there is no harmonized hedge fund regulation. Many countries deem the risks associated with the hedge funds differently and the rules found vary significantly. Due to the regulation being so different across the EU, it is rather difficult for funds to sell their products across the different countries. Many countries are also still developing their regulation. The EU expert group recommends the EU to initiate talks and legislation that will provide the European market with a harmonized hedge fund product that will enable funds to be easily sold cross-border¹⁶⁸.

In brief, to mitigate the risks, in most of the countries, hedge fund advisers are, or soon will be, regulated. Some countries prefer to regulate the fund itself, others only the hedge fund manager. Many member jurisdictions regulate both the hedge fund and the hedge fund manager. Various member states have chosen to regulate the distribution of hedge funds and the information the funds provide to their customers¹⁶⁹.

As the present legislation throughout the EU is so diverse, numerous comparative documents have been produced by organizations such as IOSCO, The European Fund and Asset Management Association (EFAMA) and Price waterhouseCoopers (PWC) that compares the differences and opportunities available throughout the different countries. So far, I have had the aim to provide the reader with a basic overview of the UK legislation and the legislation initiated at an EU level but in this chapter, I will try to provide an overview of the diverse approaches taken by other EU countries as well. The EU countries I have chosen are the countries with the largest financial sectors in the EU. Switzerland is also included in this chapter even though it is not an EU country. Switzerland is, in the financial world, due to its foreign policy a large player and most if not all international financial institutions has some presence in the country.

For those interested in the U.S. regulation I recommend the book “U.S. Regulation of Hedge Funds”¹⁷⁰.

¹⁶⁸ The European Commission’s Internal Market and Services Discussion Group: “Report of the Alternative Investment Expert Group – Managing, Servicing and Marketing Hedge Funds in Europe”, (ECEGHF), July, 2006. p. 36.

¹⁶⁹ IOSCO p. 3

¹⁷⁰ Hammer, Douglas; Haynes, Geoffrey; Reiser, Carolyn S, The American Bar Association, 2005. For readers interested in a comparison between the US, UK and Swedish regulation I recommend the Master thesis “Hedge funds, risk and regulation – A study of the regulatory engagement in the United States, the United Kingdom and Sweden” by Alexandra Vaissi, at the Faculty of Law, Lund University, 2007.

6.1 What national legislative measures govern hedge funds

France	<ol style="list-style-type: none"> 1. Financial Security Law of 1 August 2003: <ul style="list-style-type: none"> • Art. L.214-35 and L.214-35-1, • Art. L.214-35-2 to L.214-35-6 2. Decree n° 89-623 of 6 September 1989 modified by Decree n° 2003-1103 of 21 November 2003 (Art. 14 to 14-6) for funds with lightened investment rules and fund of hedge funds. 3. Commission des Opérations de Bourse position of 3 April 2003; 4. Autorité des Marchés Financiers general regulation (November 2004); 5. Decree n° 89-623 of 6 September 1989.
Germany	<ol style="list-style-type: none"> 1. “Investmentgesetz” (Investment Act) of 1 January 2004; 2. “Investmentsteuergesetz” (Investment Tax Act) of 1 January 2004.
Ireland	<ol style="list-style-type: none"> 1. Unit Trusts Act 1990; 2. Part XIII Companies Act 1990; 3. Investment Limited Partnership Act 1994; 4. Irish Financial Services Regulatory Authority Non-UCITS Notices: NU Notice 1, 12, 13, 16, 19, 20, 21, 24, 25;5; 5. Irish Financial Services Regulatory Authority Guidance Notes: 1/97, 1/01, Draft -/04.
Italy	<ol style="list-style-type: none"> 1. Treasury Ministry Decree n° 228 of 24 May 1999; 2. Bank of Italy regulation of 14 April 2005.
Luxembourg	<ol style="list-style-type: none"> 1. General legislative framework: Law of 20 December 2002 on undertakings for collective investment; 2. Specific regulation: <ul style="list-style-type: none"> • IML Circular 91/75 of 21 January 1991, • CSSF Circular 02/80 of 5 December 2002.
Spain	<ol style="list-style-type: none"> 1. Law 35/2003 of 4 November 2003;
Sweden	<ol style="list-style-type: none"> 1. Swedish Investment Funds Act (2004:46); 2. Finansinspektionen’s regulatory code (FFFS) 2004:2 “Föreskrifter om Investeringsfonder” (regulates Swedish registered FMC and harmonised/non-harmonised funds incl. hedge funds); 3. Finansinspektionen’s regulatory code (FFFA) 2004:3 ”Föreskrifter om utländska förvaltningsbolag och fondföretags verksamhet i Sverige” (regulates foreign FMC and investment funds incl. hedge funds).

Switzerland	Investment Funds Act 1994 with Ordinances.
-------------	--

¹⁷¹

6.2 Is the term hedge fund defined

France	No
Germany	No
Ireland	No
Italy	No
Luxembourg	No
Netherlands	No
Portugal	No
Spain	No
Switzerland	No
United Kingdom	No

¹⁷²

No country in the EU has defined the term hedge fund and nor has any other country throughout the world¹⁷³. For example, in France, hedge funds are allowed but are not called hedge funds but are rather referred to as “multi-market category of funds”¹⁷⁴. In Germany, the funds are called “funds with additional risks”¹⁷⁵. In Italy, the funds are called “Fondi Speculative” (speculative funds)¹⁷⁶. All countries can be said to identify hedge funds as: “every other fund than the ones defined”, which can practically mean anything.

If the EU was to define hedge funds and create a legislation that enables hedge funds to be sold easily cross border like UCITS funds, the term has to be defined and that is not easily done. A hedge fund is really an investment vehicle with no restrictions. A hedge fund is hence defined, not for what it is, but for what it is not. The EU will probably never let a fund with no investment restrictions to be sold easily cross border as an investor would face no limits for his risk exposure if all types of investments, such as extremely high leverage and all the funds capital invested in one asset, were allowed. However, the European Commission’s expert group on hedge funds recommends the Commission to initiate legislation that will make the selling of fund of hedge funds cross border possible. The expert group does not recommend the commission to reopen the negotiations on the key

¹⁷¹ EFAMA, “Hedge Funds Regulation in Europe – A Comparative Survey”, November 2005, (EFAMA) p. 11.

¹⁷² IOSCO: “Final Report – The Regulatory environment for hedge funds, a survey and comparison”, November 2006, p. 22.

¹⁷³ IOSCO p. 22

¹⁷⁴ IOSCO p. 29

¹⁷⁵ IOSCO p. 29

¹⁷⁶ EFAMA p. 12

provisions of the UCITS directive and change it again, but rather to allow UCITS to invest in derivatives on hedge fund indices¹⁷⁷.

6.3 What types of hedge funds can be set up

	Single Hedge Fund (SHF)	Fund of Hedge Funds (FoHF)
France	Yes	Yes
Germany	Yes	Yes
Ireland	Yes	Yes
Italy ¹¹	Yes	Yes
Luxembourg	Yes	Yes
Spain	Yes	Yes
Sweden	Yes	Yes
Switzerland	Yes	Yes

¹⁷⁸

All countries allow funds to be set up. If they would not, the industry and the investment experts would definitely leave the countries instantly and a source of income and knowledge would be lost. No country wishes to out rule hedge funds, as they are important for liquidity and portfolio diversification. Risk mitigation is more often found in the way the funds are sold to investors and how the domestic funds invest the funds' capital.

6.4 Hedge funds permitted to advertise

France	Yes, if the fund is registered
Germany	No
Ireland	Yes, if the fund is registered
Italy	No
Luxembourg	Yes, if the fund is registered
Netherlands	Yes

¹⁷⁷ The European Commission's Internal Market and Services Discussion Group: "Report of the Alternative Investment Expert Group – Managing, Servicing and Marketing Hedge Funds in Europe", (ECEGHF), July, 2006. pp. 21-22.

¹⁷⁸ *Ibid* p. 13.

Portugal	Yes, if the fund is registered
Spain	Yes, if the fund is registered
Switzerland	Yes, if the fund is registered

179

As can be seen, different countries deem the risks associated with hedge funds differently. Germany and Italy does not allow hedge funds to advertise at all whereas countries such as France, Ireland, Luxembourg, Portugal, Spain and Switzerland do not see a problem with advertisements as long as the funds are registered. In the Netherlands, the authorities do not view advertisements to be a problem at all.

6.5 Are there limits to how single hedge funds (SHFs) can invest?

	Yes	No
France	<p>Regulated limits depending on the type of structure:</p> <p>“Simple Funds”:</p> <ul style="list-style-type: none"> • use a leverage up to 200% of the fund’s net assets (like UCITS); • invest up to 50% of the fund’s net assets in share/units issued by a single collective investment scheme and up to 35% of the fund’s assets in bonds or equities issued by a single entity. <p>”More Advanced” :</p> <ul style="list-style-type: none"> • use a leverage up to 400% of the fund’s net assets. 	<p>“Advanced funds”:</p> <p>No legal limits, but detailed investment rules, instruments and limits must be disclosed in the prospectus.</p>
Germany	<p>Risk diversification must be obtained, max. 50% of assets in SHFs. Max. 10% of assets in each SHF, max. 30% private equity.</p>	
Ireland	<p>“Less Advanced”: Generally 20% concentration limit.</p>	<p>“More advanced”:</p> <p>Must comply with principles of risk-spreading.</p>
Italy		No limits
	<p>1) Risk diversification rules relating to short sales;</p> <p>2) Borrowings;</p>	

¹⁷⁹ IOSCO: “Final Report – The Regulatory environment for hedge funds, a survey and comparison”, November 2006, p. 23.

Luxembourg	3) Supplementary investment restrictions. Use of financial derivative instruments and other techniques.	
Spain	Leverage limited to fivefold the assets; Not permitted to invest in raw materials; Risk diversification is not applied.	
Sweden	No legislative restrictions other than compliance with principle of risk-spreading.	
Switzerland	Restrictions to be found in the fund's own rules	

180

Here we see that different countries use different rules. Very often, the domestic funds have a concentration limit and must follow rules regarding risk spreading. In Italy, we have seen that the funds cannot advertise but instead there are no limits regarding how the fund's capital is invested. In Spain, the funds can advertise but instead there are limits regarding how the fund's capital is invested. If it is easy to get access to hedge funds for retail investors, there are often restrictions on how the funds can invest the fund's capital.

6.6 Is the hedge fund manager regulated

France	Yes
Germany	No
Ireland	Yes
Italy	Yes
Luxembourg	Yes
Netherlands	Yes
Portugal	Yes
Spain	Yes
Switzerland	Yes

181

Almost all the countries regulate the hedge fund manager in order to mitigate the risks. At present, Germany does not have a regulation of the hedge fund manager. To mitigate the risks, Germany has a rather strict

¹⁸⁰ EFAMA, "Hedge Funds Regulation in Europe – A Comparative Survey", November 2005. p. 15.

¹⁸¹ IOSCO: "Final Report – The Regulatory environment for hedge funds, a survey and comparison", November 2006, p. 23.

regulation regarding the funds investment possibilities¹⁸² and the funds are not permitted to advertise.

6.7 Is the hedge fund itself regulated

France	Yes
Germany	Yes
Ireland	Yes
Italy	Yes
Luxembourg	Yes
Netherlands	Yes
Portugal	Yes
Spain	Yes
Switzerland	Yes

¹⁸³

All the countries have chosen to regulate the funds directly to mitigate the risks.

¹⁸² IOSCO p. 23.

¹⁸³ *Ibid* p. 25.

7 Concluding analysis and ending thoughts

7.1 Systematic Risk and Regulatory arbitrage - jurisdictions

As can be seen when studying the efforts to mitigate the risks through regulation in the text above; it is mainly about jurisdiction. The funds main concerns are low taxes and no disclosures. The funds have the possibilities to choose the most favourable jurisdiction and if one country changes its rules, taxes, disclosure requirements etc; the fund, its managers and administrators can easily move. The hedge fund industry is a source of income for countries and no country wishes the industry to change jurisdiction which would even further reduce the effects of the authorities' attempts to mitigate risks.

Because of the jurisdictional issues and the international character of some of the risks, countries work together to resolve the most important issues. Through international forums such as the Basel, FSF, IOSCO, EU etc, the systematic risks to the financial systems are dealt with. The risks posed to the individual investors and the financial system and the aim of creating a common investment market in Europe has now put hedge funds at the top of the agenda in the EU and the western world. When Germany took over the presidency of the G-8 in 2007 it put hedge fund transparency on the agenda for the 2007 meeting of G-8 finance ministers¹⁸⁴. The industry itself has also realised that it will benefit all market participants if a working hedge fund market, free from fraudsters, could be created and therefore both the industry and the authorities are working together in an effort to create a healthy hedge fund industry even though it is based offshore. The industry has issued guidelines through the Alternative Investment Management Association's (AIMA's) 'Guide to Sound Practices for European Hedge Fund Managers' in August 2002 and in May 2007, it was updated¹⁸⁵.

A big problem that prevents risk mitigation is the existence of offshore tax haven centres like the Cayman Islands. These tax havens sole incomes are often due to soft regulation and low taxes, which diminishes the impact of the risk mitigation attempts throughout the world. The FSF noticed this and started in 1999 a working group to consider the implications of offshore financial centres (OFCs) for global financial stability¹⁸⁶. The UK and the

¹⁸⁴ *Financial Times*, "Hedge Fund Transparency put on G8 Agenda," p. 9, October 18, 2006.

¹⁸⁵ www.aima.org/uploads/AIMApublishesrevisedGuidetoSoundPracticesMay07.pdf

¹⁸⁶ The Financial Stability Forum Working Group: 'Offshore Financial Centres', April, 2000, see: http://www.fsforum.org/publications/publication_24_75.html

EU are not domiciles of choice for funds because of the taxes, the demand for consumer protection and regulation of the financial markets.

Big institutions such as pension funds are progressively more entering the market, which affects all areas, and because of their large amounts of assets; good standards are encouraged to be developed without the intervention of regulators¹⁸⁷. Another trend in the industry is that the hedge fund managers increasingly more appoint senior executives from investment banks and other prominent businesspersons to their boards in order to gain confidence from the markets, which might be necessary if large institutions are to put big money into the funds¹⁸⁸.

In his book “Hedge Fund Regulation in the Aftermath of Long-Term Capital Management” the author Paul Roth argues that the market forces will prevent hedge funds from excessive leveraging as the counterparties will not tolerate a lack of discipline and the tough competition in the marketplace will put inefficiently run hedge funds out of business¹⁸⁹. However, that the industry will efficiently mitigate all the risks itself is too much to hope for according to me. As long as there is no efficient international regulation (even if the Basel rules have proved very helpful), risks cannot be directly mitigated. If the market forces can mitigate the risks, will we have to suffer a full financial crisis first and if so, would it be worth it if we can avoid it?

To avoid the risk to the global financial stability, even though it might seem farfetched, I would in the future like to see a truly international financial marketplace with harmonized rules in order to avoid regulatory arbitrage. In order to achieve this, a common marketplace with common rules must be created, perhaps something that is similar to the EU. The thought of a “Global Union” does sound very distant but on the other hand: the thought of a European Union with 25+ member states did sound rather unlikely before the Berlin wall fell as well.

7.2 The risk to the individual investor – (un)necessary?

Even though it is easy to find risks associated with hedge funds, we must not forget why the funds exist to begin with: there is a demand for them. If it were not for the investors’ demand for the funds, there would not be a hedge fund industry.

Legislators across the EU are concerned about the hedge funds’ strategies and the fact that there are risks regarding the valuations of the fund’s assets

¹⁸⁷ See chart 7 in Supplement A.

¹⁸⁸ Schurr, “You have met the cowboys, now meet the hedge fund organisation man” *Financial Times*, April 17, 2006.

¹⁸⁹ Roth, P.N. and Fortune, B.H., *Hedge Funds: Law and Regulation*. Sweet & Maxwell Ltd, 2001 pp. 98-102.

etc. This concern for systematic and individual risks has resulted in massive legislation but is it really necessary for legislators to interfere and legislate against the promoting of the funds or at least fund of funds to investors? Professor Charles Goodhart at LSE claims that regulation is about considering costs and benefits¹⁹⁰, and I agree. In that light; the hedge funds have, during the past decade, produced far better results for the investors than mutual funds and this to a lower risk. During the downturn on the stock market in the years 2000 – 2002, mutual funds lost endless amounts of money yet they were allowed to advertise their funds to the public. Hedge funds were not allowed to advertise their funds to the public yet they made more money, at a lower risk, for their investors during the same time period.

Jon Danielsson and his co-writers argues in an article that we must not regulate in absurdum so that all the benefits of the hedge funds seizes to exists just so we can eliminate all the risks¹⁹¹. This is also something I agree to. The problem, as I see it, is that the hedge funds are rather new, exotic and uses strategies that the legislators and the academics not always understand. This, together with the hedge funds being set up in light touch, offshore jurisdictions, has scared the legislators and individual investors have not been able to get easy access to the funds as a result. The effect has been that institutional and the high net worth investors who understands the hedge fund industry and the advantages that are associated with different investment strategies has benefited from the new way of managing risk whereas retail investors has not. Legislators have been concerned about the fact that hedge funds due to their structures and strategies can constitute a risk to the individual investor and therefore not even funds of hedge funds have been considered suitable as CISs and UCITS and hence not marketable to the public in the EU. One thing we must keep in mind though, as Professor Goodhart points out, is that if we regulate away all risks we might also regulate away the whole function of hedge funds and the financial markets¹⁹², and that will not benefit anyone.

I truly questions if the legislators in the UK and in the EU really have helped the consumers or actually made it worse for them. Hedge funds have in general produced better results with less risk than any other investment vehicles. In a court of law, an individual prosecuted for a criminal offence would not be deemed guilty until the opposite has been proved but the hedge fund industry has been found guilty without a proper trial in my opinion. There has not been a wide problem with misevaluations, nor have there been many frauds committed. I believe it is time for the legislators in the EU to face the facts and help retail investors get easy access to funds of hedge funds that can be sold cross border. If a retail investor would get easy access to a wide range of funds of hedge funds, the investor could better

¹⁹⁰ Goodhart, Charles...[et al.] *Financial Regulation: Why, how and where now?*, Bank of England, 1998, p 14.

¹⁹¹ Danielsson,Jon; Taylor, Ashley; Zigrand, Jean-Pierre, 'Highwaymen or Heroes: Should Hedge Funds be Regulated?', London School of Economics, September 2005.

¹⁹² Goodhart, Charles...[et al.] *Financial Regulation: Why, how and where now?*, Bank of England, 1998, p 14.

diversify his portfolio and reduce his risk and that is what the legislators should have in mind.

7.3 Complex financial products and legislation.

The risk of fear for complex and advanced financial products leads me in to my next question: should the financial industry and the financial products be regulated by the parliaments across the EU and the globe or by special authorities such as the FSA in the UK? In the UK it has clearly worked as the UK has the largest financial industry in Europe while at the same time have not experienced more problems than other jurisdictions where the national equivalents to the UK's FSA do not legislate. Even Ben Bernanke is in favour of giving the authorities more power and I agree. The financial markets have become so complex and inventive that it takes special knowledge and expertise to understand them. New products are constantly invented and sold as there is a demand for them by investors and persons trying to manage risks. Should then parliaments and politicians across the EU prevent these persons managing their risks just because they can not legislate quickly enough or prevent financial products being sold just because they do not understand them and thereby fear them? History has shown that man fears what he does not understand. For example, if it was not for the FSA being able to use an ad-hoc approach and relying on the FSA's principles, investors in funds using side letters would have been mistreated. I believe it is in the interest of everyone if the markets were regulated by those who fully understands them. Parliaments and politicians do not decide which advanced pharmaceuticals should be allowed to be sold to the public, a special authority does. It is my view that it is in the best interest of the consumer and the society if the financial authorities across the globe could all use an ad-hoc approach which would allow them to quickly react to potential threats to consumers and the financial system.

7.4 Future challenges

During the past 5 years, up until the end of the summer of 2007, the volatility on the markets have been generally low, the financial markets have boomed and not many investors have lost money. In such an environment, it is hard to see which funds will fail if/when the market turns and the implications of such failures. The usage of derivatives has grown and even though the leverage used by hedge funds is nowhere near what it was 8-10 years ago, a shock to the financial system will still affect hedge funds as they generally are leveraged¹⁹³.

During the late summer and fall of 2007, the credit crunch hit the global markets and suddenly the markets fell and volatility went up. It is still too

¹⁹³ Sir John Gieve, Deputy Governor at the Bank of England noted the extraordinary good times during the past 5-6 years and expressed his concern over the in real life untested risk systems in a speech at the Hedge 2006 Conference in October 2006.

early to see the full effect of this turmoil that started in the American home-loan sector and spread to the structured products, then to the whole credit market and then to the rest of the financial markets. Even though it may seem unreasonable that all markets should be affected by something that appears to be so isolated as the home-loan markets in the U.S., we definitely have proof that the markets are more correlated than investors perhaps thought. In my opinion, what has happened is that the price of risk has suddenly changed, and when that happens, all assets carrying risk, i.e. all of them, has been revaluated. Even assets with credit ratings of AAA (the highest credit rating), have been largely affected. Normally, the AAA rated assets are the most liquid products on the markets but as there has been a complete revaluation of risk, liquidity has disappeared and that has caused big problems for all financial institutions as they see the assets on their balance sheets diminish in value. An effect of this is that the ECB has had to enter the money markets on several occasions during the last months of 2007 as banks have lost trust in each other's risk management and ability to repay short-term loans to other banks¹⁹⁴.

The fundamental valuation the institutions have used has suddenly become irrelevant to the market participants and as there are no buyers to the otherwise considered risk free assets as the AAA rated bonds are, the prices have plummeted. From this, at least I draw the conclusion that liquidity is a huge risk factor to take into consideration. What does it matter what the pricing models say is the appropriate price if there are no buyers on the markets and investors are forced to close their positions?

We still do not know the full effect of the credit turmoil but if the otherwise liquid assets have been hit so hard, what has then happened to the illiquid products used by so many hedge funds? What we do know is that Bear Sterns, one of Wall Street's largest investment banks, during the fall has had to close down two of its hedge funds due to massive losses. Bear Sterns is a bank whose financial situation is constantly communicated to the market so one can only speculate in what has happened to all of the more anonymous actors in the hedge fund industry as they have seen their risk systems fail. In the future, I believe the aspect of liquidity will play a larger role in the area of risk mitigation.

It is easy to point at different aspects that can be improved but the most important thing is that there is a framework and forum for risk management, such as Basel. Specific risks may change over time but what I see as the most crucial part in order to avoid market disturbances due to systematic risk is that there is a legal framework that ensures proper risk management among the largest institutions on the financial markets. To successfully achieve this, the regulation must be drafted and implemented by those who understands it. It is not just a matter of legal and political knowledge and experience, everything that affects the financial industry's decision making process must be taken into account which is why experts from the

¹⁹⁴ Atkins, Ralph; Oakley, David; Simensen, Ivar: '*ECB set to pump cash into money markets*' Financial Times, Nov 23, 2007.

disciplines of law, audit, finance, banking and politics must all take part in any discussions that are to be held. By regulating the hedge funds counterparties efficiently, I hope that we successfully can enjoy the fruits of the new, innovative investment vehicles. By offering investors new ways of diversifying their portfolios and distribute risk from those who wants to reduce their risk exposure to those who wish to increase theirs, and thereby create efficient markets, I believe we can all benefit.

Supplement A

All charts have been taken from the International Financial Services' (IFSL) report: "Hedge Funds", March, 2007.

Supplement B

Typical structure of a hedge fund¹⁹⁵

¹⁹⁵ DP05/4 p. 69, see also: chart 16 in Supplement A.

Bibliography

Books

Hammer, Douglas; Haynes, Geoffrey; Reiser, Carolyn S: *U.S. Hedge Fund Regulation*, The American Bar Association, 2005.

Hull, John: *Options, Futures and Other Derivatives*, 6th edition, Prentice-Hall, 2005.

Lowenstein, Roger: *When Genius Failed: The Rise and Fall of Long-Term Capital Management*, Random House, 2001.

Pettet, Ben: *Company Law*, 2nd edition, Pearson Longman, 2005.

Roth, P.N. and Fortune, B.H., "Hedge Fund Regulation in the Aftermath of Long-Term Capital Management", *Hedge Funds: Law and Regulation*. Sweet & Maxwell Ltd, 2001.

Zask, Ezra: *Global Investment Risk Management*, McGraw-Hill, 1999.

Articles

Atkins, Ralph; Oakley, David; Simensen, Ivar, "ECB set to pump cash into money markets", *Financial Times*, Nov 23, 2007.

Cantrell, Amanda: "Hedge fund fraud much higher in U.S." *CNN Money*, October 27, 2005.

Cantrell, Amanda: "Hedge fund has-beens" *CNN Money*, July 11, 2005.

Davis, Ann; Sender, Henny and Zuckerman, Gregory, "What Went Wrong at Amaranth," *The Wall Street Journal*, Sept. 20, 2006.

Eichenwald, Kurt: "Computer-trading outcry forcing change" *The New York Times*, November 2, 1989.

Fama, Eugene: "The Behaviour of Stock Market Prices" *Journal of Business*, January 1965.

Grant, Jeremy: "Bernanke calls for UK-style regulation", *Financial Times*, May 15, 2007.

Jenkins, David: "The long and short" *The Guardian*, September 24, 2005.

Loomis, Carol: "The Jones nobody keeps up with" *Fortune magazine*, April 1966.

Schurr, Steve: “Global hedge funds top \$1,500bn” *Financial Times*, March 27, 2006.

Schurr, Steve: “You have met the cowboys; now meet the hedge fund organisation man” *Financial Times*, April 17, 2006.

Taub, Stephen: “Alpha Profiles the Top 25 Money Makers” *Alpha Magazine*, April 20, 2007.

White, B. And Mackintosh, J: “Top hedge fund AQR eyes public offering”, *Financial Times*, April 21, 2007.

Statutes, Directives and Rules

The Financial Services and Markets Act 2000 (FSMA)

Statutory Instruments

Financial Services and Markets Act 2000 (Regulated Activities) Order 2001
SI 2001 No. 544

The Financial Services Authority’s Handbook of Rules and Guidance

The Financial Services Authority’s Conduct of Business Sourcebook

The Financial Services Authority’s Collective Investment Schemes
Sourcebook

The Financial Services Authority’s General Prudential Sourcebook

The Financial Services Authority’s Principles for Business rules

The Financial Services Authority’s Senior Management Arrangement,
Systems and Controls Sourcebook

European Legislation

Directive 1985/611/EC

Directive 1991/308/EC

Directive 1993/6/EC

Directive 2001/97/EC

Directive 2001/107/EC

Directive 2001/108/EC

Directive 2003/6/EC

Directive 2003/71/EC

Directive 2004/39/EC

Directive 2004/109/EC

Directive 2005/60/EC

Directive 2006/48/EC
Directive 2006/49/EC

Financial Services Authority Statements

Financial Services Authority Statement, '*Hedge fund manager withdraws from industry following fund overvaluation*', March 23, 2006.

Financial Services Authority Speeches

Davies, Howard (former chairman, FSA): '*Shedding Light on Hedge Funds*', Speech, May 3, 2000.

McCarthy, Callum (chairman, FSA): '*Risk based regulation: the FSA experience*', Speech, February 13, 2006.

McCarthy, Callum (chairman, FSA): '*Hedge Funds: what should be the regulatory response?*', Speech, December 7, 2006.

Financial Services Authority Press Releases

FSA press release: FSA/PN109/2006, 31 October 2006.

Governmental Reports

Adrian T., Measuring risk in the hedge fund sector, *Current Issues* Volume 13, Number 3 March/April 2007 Federal Reserve Bank of New York.

Basel Committee on Banking Supervision, '*Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework*', 2005.

Basel Committee on Banking Supervision, '*Sound Practices for Banks Interactions with Highly Leveraged Institutions*', 1999.

Crockett, A: '*The evolution and regulation of hedge funds*' Financial Stability Review edited by Banque de France, special issue on hedge funds, April, 2007.

European Central Bank Occasional Papers, '*Hedge funds and their implications for financial stability*', August, 2005.

European Central Bank, Financial Stability Review, June 2006.
<http://www.ecb.int/pub/pdf/other/financialstabilityreview200606en.pdf>

European Commission's Internal Market and Services Discussion Group, '*Report of the Alternative Investment Expert Group – Managing, Servicing and Marketing Hedge Funds in Europe*', July, 2006.

European Commission Internal Market and Services Discussion Group, *'Report of the Alternative Investment Expert Group – Developing European Private Equity'*, July, 2006

European Parliament Draft Report, *'The international monetary system – how to make it work better and avoid future crises, 2000/2017(INI)*. July, 2001.

Financial Services Authority, *'The FSA's Assessment framework'*, August, 2006.

Financial Services Authority Consultation Paper 06/19, *'Reforming Conducts of Business Regulation'*, October, 2006.

Financial Services Authority Consultation Paper 06/20, *'Financial Promotion and other communications'*, October, 2006.

Financial Services Authority Consultation Paper 07/6, *'Funds of Alternative Investment Funds'*, March, 2007.

Financial Services Authority Discussion Paper 05/03, *'Wider-range Retail Investment Products – Consumer protection in a rapidly changing world'*, 2005.

Financial Services Authority Discussion Paper 05/04, *'Hedge Funds: A discussion of risk and regulatory engagement'*, 2005.

Financial Services Authority Discussion Paper 05/2, *'Stress testing'*, 2005.

Financial Services Authority Feedback Statement 06/2, *'Hedge funds: A discussion of risk and regulatory engagement - Feedback on DP05/4'*, 2006.

Financial Stability Forum, *'Report of the Working Group on Highly Leveraged Institutions'*, 2000.

Financial Stability Forum, *'The FSF Recommendations and Concerns Raised by Highly Leveraged Institutions: An Assessment'*, 2002.

Financial Stability Forum, *'Offshore Financial Centres'*, April, 2000.

Goodhart, Charles; Hartmann, Phillip; Llewellyn, David; Rojas-Suarez, Liliana and Weisbrod, Stephen, *Financial Regulation: Why, how and where now?* Bank of England, 1998.

IOSCO, *'Final Report – The Regulatory environment for hedge funds, a survey and comparison'*, November, 2006.

IOSCO Consultation Report, *'The regulatory environment for hedge funds. A survey and comparison'*, March 2006.

IOSCO/Basel Committees, '*Review of Issues Relating to Highly Leveraged Institutions*', 2001.

U.S. President's Working Group on Financial Markets, '*Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*', April, 1999.

Other Reports

Daniélsson, J.; Taylor, Ashley; Zigrand, Jean-Pierre, '*Highwaymen or Heroes: Should Hedge Funds be Regulated?*', London School of Economics, September, 2005.

European Fund and Asset Management Association, '*Hedge Funds Regulation in Europe – A Comparative Survey*', November, 2005.

International Financial Services London, '*Hedge Funds*', March, 2006,

International Financial Services London, '*Hedge Funds*', March, 2007.

International Financial Services London, '*International Financial Markets in the UK*', November, 2006.

Lastra, Maria, '*The Governance Structure for Financial Regulation in Europe, London*', LSE Financial Markets Group, 2001.

Vaissi, Alexandra: '*Hedge funds, risk and regulation – A study of the regulatory engagement in the United States, the United Kingdom and Sweden*', Master thesis, Lund University, 2007.

Waleck et Associates, '*100 times a day, hedge funds and the media*', 2006.

Other sources*

'*History of the Basel Committee and its Membership*', found online at <http://www.bis.org/bcbs/history.htm>

'*Financial Compensation Scheme*', found online at <http://www.fscs.org.uk/>

'*Financial Services Compensation Scheme – compensation limits*', found online at http://www.fscs.org.uk/consumer/key_facts/limitations_of_the_scheme/compensation_limits/

'*Financial Stability Forum – who we are*', found online at http://www.fsforum.org/about/who_we_are.html

'*Basel Committee on Banking Supervision*', found online at

http://www.fsforum.org/compendium/compendium_of_standards_issuing_body_14.html

'*SEC to strengthen rules on hedge fund fraud and qualifying investors*', 15 December, 2006, found online at

http://www.hedgeweek.com/articles/detail.jsp?content_id=42798

'*London as a financial centre*', found online at

<http://www.london.gov.uk/london-life/business-and-jobs/financial-centre.jsp>

'*London: Center of international finance*', June, 2003, found online at

<http://web.uflib.ufl.edu/cm/business/cases/london.htm>

Harper, David: '*Introduction To Hedge Funds*', November 26, 2003, found online at <http://www.investopedia.com/articles/03/112603.asp>

Humer, Caroline: '*Merger talk: Unusual trading surrounds biggest deals*', Reuters Online, April 5, 2007 found online at

https://secure.reuters.com/news/articleinvesting.aspx?type=mergersNews&storyID=2007-04-05T153945Z_01_N05184026_RTRIDST_0_COLUMN-MERGERS-SCHEDULED-WEEKLY-COLUMN.XML

Securities and Exchange Commission, [Release No. 33-8766; IA-2576; File No. S7-25-06], '*Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*', December 27, 2006, found online at

<http://www.sec.gov/rules/proposed/2006/33-8766.pdf>

Securities and Exchange Commission, [Release No. IA-2266; File No. S7-30-04], '*Registration under the Advisers Act of Certain Hedge Fund Advisers*', July, 2003, found at <http://www.sec.gov/rules/proposed/ia-2266.htm>

Testimony of Richard R. Lindsey, Director SEC Division of Market Regulation before the House Committee on Banking and Financial Services, Concerning Hedge Fund Activities in the U.S. Financial Markets, found online at

<http://www.sec.gov/news/testimony/testarchive/1998/tsty1498.htm>

* *All internet addresses last downloaded 2007-11-20*