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# Alternative Investment Vehicles & (Self)-Regulation\*

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1. – In a recent discussion on how and why to regulate hedge funds from a US perspective, Professor Paredes<sup>1</sup> – having correctly acknowledged that hedge funds promote market efficiency, add liquidity to the financial markets, provide opportunities for businesses and investors to shift and manage risk and act as shock absorbers that can stabilize financial markets during crisis but, at the same time, may propagate systemic risk – summarized four basic choices: (1) do nothing; (2) substantively regulate hedge funds directly; (3) regulate hedge fund managers, and (4) regulate hedge fund investors. The last approach, complemented with a new anti-fraud provision, was finally adopted by the S.E.C. after the Court of Appeal for the District of Columbia vacated, on June 23, 2006, in *Goldstein* the then newly enacted Hedge Fund Rule which (under the third possible approach in the above list) attempted on the contrary to regulate hedge fund managers as Investment Advisers under the Investors Advisers Act of 1940 (by considering the hedge fund investors as clients of the fund manager).

2. – Indeed, the regime following *Goldstein*, on one hand, brought about a new anti-fraud provision which “prohibits advisers to pooled investment vehicles from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in those pooled vehicles”, whereby conferring clear authority to the Commission to bring enforcement actions against investment advisors who defraud investors in a hedge fund or in any other pooled investment vehicle (thereby providing a legal basis for their market integrity control); on the other hand, such new regime revised the requirements for determining whether an individual is eligible to invest in certain pooled investment vehicles, thereby introducing the new “accredited natural person” category designed to ensure, through the increase of the parameters of investor wealth (untouched since 1982, despite inflation, and now set at 2,5 million in investments), that investors in these types of funds are capable of evaluating and bearing the risks of their investments. Alongside with these innovations, which in the words of the Commission, “have the potential to enhance substantially the protection for investors and potential investors in hedge funds and other similar funds”, the U.S. confirmed



\* Speaking note of the testimony before the Legal Affairs Committee of the European Parliament at the Public Hearing “Transparency of Institutional Investors”, 25 February 2008.

<sup>1</sup> T. PAREDES, “Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation”, *Washington University, Faculty working paper series*, paper no. 07-05-01, May 2007, 3; ID., “On the Decision to Regulate Hedge Funds: The SEC’s Regulatory Philosophy, Style and Mission”, *Washington University, Faculty working paper series*, paper no. 06-03-02, March 2006 (both advocating for a best practice oriented mode of regulation).

their reliance in principle to market discipline: *a market discipline guided and closely monitored, though.*

3. – In fact, in February 2007 the President Working Group on Financial Markets (which had already issued a first set of recommendations in 1999 in the wake of the near collapse of the Long-Term Capital Management fund, noting that “in our market-based economy, market discipline of risk taking is the rule and government regulation is the exception” but also warning that, if market participants had not effectively followed the suggested measures, “there are several matters that could be given further consideration”) issued a set of illustrative “soft law” principles and guidelines “regarding private pools of capital”. These principles cover both investor protection and systemic risks worries. According to Principle no. 2 “market discipline most effectively addresses systemic risk posed by private pools of capital. Supervisors should however use their existing authorities with respect to creditors, counterparties, investors and fiduciaries – *thus, through the so called indirect regulation and supervision* – to foster market discipline on private pools of capital. *Investor protection concerns can be addressed most effectively through a combination of market discipline and regulatory policies that limit direct investment in such pools to more sophisticated investors*”. Under Principle no. 4 “investors in private pools of capital should obtain accurate and timely historical and ongoing material information necessary to perform due diligence regarding the pool’s strategies, terms, conditions and risk management, thereby enabling such investors to make informed investment decisions” (this principle is then detailed in 5 derivative rules). Under Principle no. 5 concerns (brought about by recent retailisation of hedge funds) that less sophisticated investors could be exposed indirectly to private pools through holdings of pension funds, fund of funds, or other similar pooled investment vehicles should be governed *again through indirect regulation* and supervision and “can best be addressed through sound practices on the part of the fiduciary that manage such vehicles. These fiduciaries have a duty under applicable law to act in the best interest of the beneficiaries. They have an ongoing responsibility to perform due diligence to ensure that their investment decisions are prudent and conform to sound practices for fiduciaries”. As to systemic risks, given the premise that there is the “possibility that losses of one or more entities could threaten the stability of the broad financial system”, Principle 7 relies on appropriate risk management, compliance and internal audit and requires that “key creditors and counterparties must commit resources and maintain appropriate policies, procedures, and protocols to define, implement and continually enhance best risk management practices. Those policies, procedures and protocols should address how the quality of information from a private pool of capital should affect margin, collateral and other aspects of counterparty risk management”: in fact, as specified under rule 7.4., “information that creditors and counterparties should seek to obtain from a private pool includes both quantitative and qualitative indicators of a private pool’s net asset value, performance, market and credit risk exposure and liquidity. The level of detail expected should respect the legitimate interest of the pool in protecting its proprietary trading strategies. Where sufficient information is not forthcoming from a particular private pool, though, “creditors and counterparties should tighten margin, collateral and other credit terms”. In turn, under Principle 9 and with clear reliance on market discipline and good standards of practice, “managers of private pools of capital should have information, valuation and risk management systems that meet sound industry practices and enable them to provide accurate information to creditors, counterparties and investors with appropriate frequency, breadth and detail”. Based upon these general principles, it is forthcoming a complete set of detailed “soft law” standards open to voluntary, albeit recommended, adoption by each fund. The U.S. industry, though, for instance through the Managed Fund Association, already provided, starting from February 2000, a comprehensive set of best practices (now the MFA’s 2005 Sound Prac-

tices for Hedge Fund Managers), including provisions and a template for anti-money laundering policies and procedures<sup>2</sup>.

4. – In the literature, especially in the U.S., views are still inclining to support a light touch in the regulation. Only to mention a few recent studies, Cumming & Que (2007)<sup>3</sup>, considering an international dataset of 2937 hedge funds from 24 countries around the world, find that – although “a lack of regulatory oversight may give rise to fund managers that disguise investment schemes and merely capture the fees” – data seem to suggest that “regulatory requirements in the form of minimum capitalization, restrictions on the location of key service providers and restriction that limit distributions to private placements tend to be associated with lower fund alphas, lower manipulation-proof performance measures, lower average returns, higher fixed fees and lower performance fees”. Oesterle (2006)<sup>4</sup> concludes that “extensive direct regulation of hedge funds is unnecessary and may harm the country’s trading markets. Indeed the dramatic growth of hedge funds is in part attributable to the current overregulation of registered investment companies. We should therefore not tighten the regulation of hedge funds but lighten the regulation of registered investment companies, strengthening however some forms of indirect regulation of hedge funds leverage, principally limits on banks that lend to and are counterparties of hedge funds”. Kambhu, Schuermann and Stiroh (2007)<sup>5</sup>, whilst recognizing that “market participant may not be sufficiently cognizant of the risks they face and therefore not vigilant enough in constraining counterparty risk” and that “systemic risk reflects an externality or public good problem, that by definition even well informed market participants will not have an incentive to adequately monitor or limit those risk-generating actions and that therefore there is a role for regulation to reduce inefficient systemic risk”, they conclude however that “the current emphasis on market discipline and counterparty credit risk management as the primary check on hedge fund risk taking is appropriate”. The authors believe that outright regulation of hedge funds is not advisable: “activity restrictions that dramatically limit trading strategies such as short selling or the use of derivatives would likely diminish the beneficial impact of hedge funds on market liquidity and price discovery. Required capital ratio would be difficult to set optimally and would lead to increased regulatory arbitrage. Outright regulation might be expected to increase moral hazard, if it increases the appearance of regulatory approval or simply the shift of the activity to a less regulated jurisdiction”. On the contrary, the mandatory provision of more and timely information that do not compromise legitimate commercial interests of the funds to regulators<sup>6</sup> and the investment community would help address the information asymmetries related to existing market failures. But since disclosure does not solve all critical issues – and “it is not clear how the official sector could effectively analyze such an enormous quantity of information or act on it given the



<sup>2</sup> Remarkable are also the recommendations and guiding principles issued by the COUNTERPARTY RISK MANAGEMENT POLICY GROUP (“Corrigan Group”), with its Report of July 2005, *Toward Greater Financial Stability: A Private Sector Perspective* (available at [www.crpmoneygroup.org](http://www.crpmoneygroup.org)).

<sup>3</sup> D. CUMMING-L.QUE, “A Law and Finance Analysis of Hedge Funds”, March 2007, available at <http://ssrn.com/abstract=946298>.

<sup>4</sup> D.A. OESTERLE, “Regulating Hedge Funds, *Center for Interdisciplinary Law and Policy Studies, Working Paper Series no. 47*, available at <http://ssrn.com/abstract=913045>.

<sup>5</sup> J. KAMBHU-T. SCHUERMAN-K.J. STIROH, *Hedge Funds, Financial Intermediation and Systemic Risk*, Federal Reserve Bank of New York, August 2007, *passim*.

<sup>6</sup> See in this respect the Highly Leveraged Institutions positions register suggested by the ECB in December 2006.

heterogeneous nature of positions and exposures”, as already pointed out by Mr. Bernanke<sup>7</sup>—transparency should be coupled with best practice techniques for risk management and measurement, improved clarity around legal arrangements for prime brokerage activities and valuation standards for complex, illiquid products. The authors conclude indeed that “this is a classic case of public good that needs to be provided by the official sector to avoid the tragedy of commons, in this case systemic risk”. In this respect Schmidt (2007)<sup>8</sup> finds that, in the field, “the United Kingdom is clearly ahead of the United States. UK regulations appear to have much closer scrutiny over fund managers’ activities”<sup>9</sup>: despite this more intrusive regulation and supervision, however, “hedge fund management is thriving in Europe and not flocking to the United States”, because “Europeans are comfortable working within their regulatory schemes”<sup>10</sup>. Thus, less is not necessarily more.

5. – As a matter of fact, in the European context there is no unified regulatory framework for alternative investment vehicles. As it has been pointed out by the recent Naik Report (2007), correctly stressing the very many anomalies existing in the current regulatory practice<sup>11</sup>, whilst qualified investors can invest in hedge funds by way of private placement but they do so without national or EU investor protection measures to support them and UCITS III funds (now enabled to use some alternative investment strategies) can be offered cross-border to retail clients without investment expertise, “in the middle there is a market of non-harmonized funds. It is through non-harmonized investment products that most investors gain access to hedge funds (and other alternative investment vehicles) and it is here that regulation across the EU is fragmented and confusing. National regulators have adopted different frameworks. Some differences are small. Others are more material but each difference raises the costs of providing investment services across Europe”. Private pools of capital do not benefit, therefore, of the European passport and, in principle, are not able to market their products across Europe (unless they abide by all different national rules applicable in each host MS). *On one side*, therefore, the regulatory debate focuses on the need to harmonize such divergent national regimes in order to foster pan-European market integration in this respect, overcoming existing national fragmentation. The Commission called, already in its Green Paper on the Enhancement of the EU Framework for Investment Funds<sup>12</sup>, for a “coherent and enlightened European approach to this sector”, envisaging “a common regulatory approach to facilitate the further development of European markets for hedge funds and private equity funds”, possibly devising common rules also on the “private placement” notion which could facilitate the cross border offer to qualified investors<sup>13</sup>. The Council, in turn, has requested in May 2007 a report,

<sup>7</sup> B.S. BERNANKE, “Hedge Funds and Systemic Risk”, Comments presented at the Federal Reserve Bank of Atlanta’s 2006 Financial Market Conference, May 16, 2006.

<sup>8</sup> M.J. SCHMIDT, ““Investor Protection” in Europe and the United States: Impacting the Future of Hedge Funds”, 25 *Wis. Int. L.J.* 1 (Spring 2007), 185.

<sup>9</sup> See also L. TIFFITH, “Hedge Fund Regulation: What the FSA is Doing Right and Why the SEC Should Follow the FSA’s Lead”, 27 *NW J. Int’l L&B* 497 (2007).

<sup>10</sup> Compare also P. YEOH, “Hedge Funds: Is the UK Regulatory Approach the Template Forward?”, *International Journal of Disclosure and Governance*, 2007, 221.

<sup>11</sup> EUROPEAN PARLIAMENT-POLICY DEPARTMENT, “Hedge Funds. Transparency and Conflict of Interest”, *IP/A/ECON/ST/2007-17* (December 2007), 18-20.

<sup>12</sup> COM (2005) 314 final.

<sup>13</sup> See also COMMISSION OF THE EUROPEAN COMMUNITIES, *White Paper on Enhancing the Single Market Framework for Investment Funds*, 15 November 2006, COM(2006) 686 final, 11-13 taking a more timid approach in respect to hedge funds and confirming action on the private placement issue.

expected by mid 2008, from the Commission on possible measures to be taken on a Single Market framework for the retail-oriented non harmonized fund industry, which might include some funds of hedge funds. The European Parliament, with the Parvis resolution first and with the Van den Burg Report<sup>14</sup> later, called, *on the other side*, for attention to the “gaps in disclosure requirements with respect to corporate governance and investment policy, on the adaptation of rules for the level of leverage and risk management and diversification; the quality of supervision in off-shore locations and to step up cooperation”.

6. – These latter concerns are tackled today in a quite differentiated way among jurisdictions<sup>15</sup>, but mostly through indirect regulation and supervision (especially from the banking side) and self-regulation. In particular, in London where most of the European managers of the industry are located and registered, this is done through a wide array of self-regulatory measures *within the general principles of supervision of FSA* (namely, the “Principles” for authorized firms and those for individuals; the rules on “Senior Management Arrangements, Systems and Controls”; the “Code of Market Conduct” and the “Conduct of Business Sourcebook”). In fact, the FSA accepts that funds be lightly regulated off-shore but regulate the managers and their activity in the U.K. The FSA philosophy is finely described in a position paper issued on March 2006<sup>16</sup>: FSA is fully aware of the risks of regulatory competition in the field and finds that it would be counter productive to increase the burden of regulation if it could result in managers moving off-shore to more lightly regulated locations. It established, though, *a dedicated supervision team: a) first to monitor on an on going basis identified risks* (such as market abuse, anti-money laundering, the control of operational risks, managing conflicts of interest but also valuation of assets, *where FSA explicitly supports the IOSCO principles*<sup>17</sup> “*for the valuation of hedge fund portfolios*”) and b) second, to review on a regular basis also those prime brokers that do have exposures to hedge funds. The supervisory approach is also careful in differentiating hedge fund managers from traditional asset managers and private equity/venture capital funds. As regards transparency *vis à vis* the investors, the FSA addresses specifically, for instance, the issue of side letters and states that “at a minimum would expect acceptable market practice to be for managers to ensure that all investors are informed when a side letter is granted”. *This finding is well illustrative of the way a principle-based supervision grounded on market practices work in practice and could usefully replicated at the EU level*: the FSA is encouraging the industry to develop a consistent market practice, warning at the same time that failure to disclose the existence of side letters would be in breach of Principle 1 of the Principles for Businesses (“a firm must conduct its business with integrity”) and, depending on the circumstances, could even amount to a criminal offence under section 397 of the 2000 FSMA. Not surprisingly, the newly issued (January 2008) Hedge Fund Standards



<sup>14</sup> PE384.621v01-00, 12 March 2007.

<sup>15</sup> For an overview: OICV-IOSCO, TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, *The regulatory environment for hedge funds: a survey and comparison*, Final Report, November 2006, where examples, at p.6, of restriction on leverage, use of derivative instruments, quantitative restriction in investments for registered or authorised collective investment schemes engaging in hedge fund like strategies. See also PRICEWATERHOUSECOOPERS, *The regulation and distribution of hedge funds in Europe, Changes and challenges*, May 2004; ASSOGESTIONI AND EFAMA, *Hedge Funds Regulation in Europe: A Comparative Survey*, November 2005.

<sup>16</sup> FSA, *Hedge Funds: A discussion of risk and regulatory engagement*, Feedback Statement 06/2, March 2006.

<sup>17</sup> OICV-IOSCO, TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, *Principles for the valuation of hedge fund portfolios*, Consultation Report, March 2007 and now OICV-IOSCO, TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, *Principles for the valuation of hedge fund portfolios*, Final Report, November 2007.

recommended by the Hedge Fund Working Group (the “Large Group”) recognize (under Standard 2) that “a hedge fund manager should disclose the existence of side letters which contain material terms and the nature of such terms”. It also recommends that in the offering document and in the audited annual reports the managers disclose the realized volatility, value at risk measures, leverage (high, low and average for the period), measures of portfolio liquidity and the investment instruments used. Some of these self-regulatory standards, albeit certainly very useful to mark an advance in the field, appear yet quite timid. As it has been correctly noted in the Naik Report<sup>18</sup> the envisaged yearly information is not enough and should be complemented by frequent and regular information made available to the investors; in turn, many of the standards rely on simple best effort duties of the senior management of the manager to encourage the directors of the (often off-shore) fund to act consistently with the standard, with no clear remedies in case of failure to comply<sup>19</sup> and with insufficient recourse to independent control (the Naik Report recommends that compliance with the code should be subject to an annual audit by the fund’s auditors which should be required to state their opinion in the annual report to the shareholders).

7. – In this context, there seem to be room for a coherent EC re-adjustment of the existing inconsistent regulatory patchwork on alternative investment vehicles which, however, should, also in my view, confirm reliance also on self-regulatory best practices and refrain from any regulatory disproportionate step which could reduce innovation (also unnecessarily banning or limiting aggressive investment strategies *or alternative funds’ activism as shareholders, which, as also shown by the recent OECD Report (2007)*<sup>20</sup> *is to be considered generally beneficial*), increase cost, adversely affect the derivative market and prompt a relocation of alternative investment vehicles off-shore. On the contrary, such re-adjustment should be so devised as to contribute to attract more investors by establishing adequate transparency standards and to increase liquidity by bringing about a real single market in lieu of the existing national fragmentation.


8. – To this purpose, taking account of the existing bifurcation of the hedge fund sector (boutiques and institutional oriented firms) following the Naik Report recommendations, alternative investment vehicles like properly diversified funds of hedge funds could be allowed to benefit of the UCITS III regime and a higher degree of cross-border retailisation, with the additional provision (as to the interplay between regulation and self-regulation) that they can invest only in funds – off-shore or on shore – that comply with recognized codes of conducts so as to provide strong market incentives to voluntary compliance. All other alternative investment vehicles should be subject to harmonized and proportionate minimum registration requirements coupled with MiFID or MiFID-like (or FSA-like) general principles for their management, under a principle based approach differentiating between the specific features of hedge fund, private equity and venture capital industries. This could not only pave the way towards mutual recognition and a coherent level playing field across Europe *but, at the same time, towards an effective supervision extensively grounded, in addition to indirect supervision on banks and*

<sup>18</sup> At p. 14.

<sup>19</sup> EUROPEAN PARLIAMENT-POLICY DEPARTMENT “Hedge Funds and Financial Stability”, IP/A/ECON/IC/2007-23, November 2007, 49.

<sup>20</sup> OECD STEERING GROUP ON CORPORATE GOVERNANCE, *The Implications of Alternative Investment Vehicles for Corporate Governance: A Synthesis of Research about Private Equity Firms and “Activist” Hedge Funds*, July 2007, *passim*

prime brokers through appropriate risk management (already grounded in the Basle II Accord and Capital Requirement Directive)<sup>21</sup>, on best market practices and self-regulatory codes of conduct. In other terms, single market reasons, self discipline and proportionate and principle-based supervision aimed at investor, market integrity and financial system protection should converge fostering at the same time the cross-border growth of the industry and its transparency and soundness (to avert systemic risk). As recently pointed out by the de Vries and Stork Report (2007)<sup>22</sup> "high levels of transparency on issues like the fee structure, the redemption policy, the valuation procedure, the investment strategy and result reporting are obvious. Better transparency on these issues is one of the main instruments to make market discipline effective and for preventing systemic disruptions"<sup>23</sup>. In turn, the CESR activity under the Lamfalussy procedure, if called into action here, should prove useful, in my view, to facilitate convergence of national supervisors not only to solve long lasting anomalies depending on the existing national fragmentation of the regulatory framework (providing e.g. a common definition of private placement<sup>24</sup> and a coherent solution to the striking anomaly of closed end fund today listed in London and in many other Stock Exchanges and thus open to retail investors and open-ended funds of hedge fund not permitted under UCITS III to retail investors, yet doing essentially the same job) but also to push ahead, from common and supervised European self-regulatory standards of conduct, the kind of trans-Atlantic and global convergence which is needed in the field<sup>25</sup>.

  
<sup>21</sup> T. GARBARAVICIUS-F. DIERICK, "Hedge Funds and Their Implications for Financial Stability", *European Central Bank, Occasional Paper Series*, no. 34, August 2005, especially at p. 49. The Authors also note, at p. 51, that "since the management of hedge funds is very international in nature, it has been argued that the hedge fund business is particularly vulnerable to money laundering attempts. Hedge fund managers should therefore duly verify, directly or indirectly through the fund's administrators, the investors in their funds".

<sup>22</sup> EUROPEAN PARLIAMENT-POLICY DEPARTMENT, (*supra*, n. 19), p. 72. The Report acknowledges, though, that it is still open the debate whether the reporting of large investment positions or large clients is useful or not with the FSA clearly against such reporting.

<sup>23</sup> A similar finding refers to private equity: see EUROPEAN PARLIAMENT-POLICY DEPARTMENT, *Private Equity and Leveraged Buy-outs*, Study IP/A/ECON/IC/2007-25 ("Gottschalg Study"), November 2007, 45 where the identification of 4 aspects of the status quo of private equity reporting practices deserving improvement: (a) the reliability and consistency of valuations for ongoing investments; (b) the heterogeneous nature of self-reported information provided in private placement memoranda and reports to investors; (c) the understatement of investment risk due to sticky valuations and (d) the potentially misleading standard return measures used to report investment and fund performance.

<sup>24</sup> As recommended also by the REPORT OF THE ALTERNATIVE INVESTMENT EXPERT GROUP, *Developing European Private Equity*, Brussels, July 2006, 4 and 28-30.

<sup>25</sup> As correctly pointed out by P.M. HILDEBRAND, "Hedge funds and prime broker dealers: steps towards a "best practice proposal"", *Banque de France, Financial Stability Review, Special issue on hedge funds*, no. 10, April 2007, 73 "a best practice proposal that is not internationally adhered to inevitably runs the risk of being without teeth or distorting competition".