Selected Questions Regarding Hedge Funds

Sebastian Schich

There has been rapid growth in the share of assets under control of hedge funds over the past decade and, as a result, these entities have now become firmly entrenched in the universe of investment vehicles and, in turn, have themselves become important investors. Against this background, the OECD Committee on Financial Markets (CMF) discussed specific issues related to these entities on several occasions as part of its market surveillance activity. The present article provides a summary of selected aspects of recent CMF discussions related to hedge funds, focusing in particular on the responses to a questionnaire on hedge funds that was circulated prior to the CMF meeting in May 2007 to inform the discussion at that meeting. These various discussions suggested that a consensus is emerging that the most efficient way to address any policy concerns related to the activity of hedge funds is to focus on hedge fund investors and counterparties rather than on these entities themselves. Only a minority of countries are considering policy actions in a variety of areas, but many respondents seem to underline the need for public authorities to continue monitoring developments regarding hedge funds.

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Background and executive summary

Background

Hedge funds have become firmly entrenched as investment vehicles and have become important investors themselves

There has been rapid growth in the share of assets under control of hedge funds over the past decade and, as a result, these entities have now become firmly entrenched in the universe of investment vehicles and, in turn, have themselves become important investors. Assets under management by hedge funds may represent less than 10 per cent of total managed funds, with the bulk under management by the global mutual fund industry, but until recently the global hedge fund universe had been growing far more rapidly than the latter.

Policy makers need to have a good understanding of the role of these entities in financial markets

Moreover, hedge funds trade more actively than many other market participants and often use leverage significantly, so that their market clout is much bigger than the size of their balance sheets might otherwise suggest. These observations suggest that policy makers need to have a good understanding of the role of these entities in financial markets.

* The author is Senior Economist in the Division for Financial Affairs in the OECD Directorate for Financial and Enterprise Affairs. The article is a revised and updated version of a note that was circulated before and discussed at the meeting of the OECD Committee on Financial Markets in May 2007. The current version takes into account the discussions and comments made by delegates at the meeting, as well as additional comments and contributions received after the meeting via the written procedure.

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Against this background, the Committee on Financial Markets (CMF) discussed specific issues related to these entities on several occasions as part of its market surveillance activity, including within the *Tour d'Horizon on Financial Markets* (TDH) at its meetings in November 2006 and May 2007.[1]

The present article provides a summary of responses to a questionnaire on hedge funds and related CMF discussions

The present article provides a summary of selected aspects of recent CMF discussions related to hedge funds, focusing in particular on the responses to a questionnaire on hedge funds that was circulated prior to the meeting in May 2007 to inform the discussion at that meeting. The note also presents the discussions of results at that meeting. In addition, it also takes into account additional questionnaire responses and comments received via the written procedure subsequent to the May 2007 meeting.

Detailed questionnaire responses from 28 CMF members have been received, which implies a response rate of around 88 per cent (as of the total number of 32 CMF members, that is 30 OECD members plus Singapore and Hong Kong, China). Such responses were received from Australia, Austria, Belgium, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hong Kong, China, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, and the United Kingdom.

The information contained in the responses to the CMF questionnaire are summarised according to five main themes (each discussed in a separate section):

I. How big is the hedge fund industry?

II. How risky are investments in hedge funds perceived to be?

III. How transparent are hedge funds?

IV. How protected are investors?

V. How directly regulated are or should hedge funds be?

Subsequently, section VI provides a summary report of the discussions at the CMF meeting in May 2007.

Selected questionnaire results

There are important similarities in views across different CMF jurisdictions

Issues related to hedge funds are complex, which was reflected in the finding that no question drew a unanimous response. Nonetheless, questionnaire responses revealed important similarities in views and practices related to hedge funds across different CMF jurisdictions.

First, there are no formal definitions of hedge funds in many jurisdictions ...

First, there are no legal/formal definitions of hedge funds in many jurisdictions and where they exist, such definitions differ across jurisdictions. Nonetheless, a majority of respondents consider that these entities distinguish themselves from other more traditional investment vehicles regarding the following features:

…but the use of "alternative strategies" is considered as a defining feature

- The use of alternative investment strategies (89%).[2]
- Lighter investment rules (63%).
- High risk exposure (59%).

Second, hedge funds give rise to policy concerns…

Second, about four fifths of respondents suggested that hedge funds and their activities raised at least one significant policy concern. The following policy concerns were considered significant by a majority of respondents:

- Transparency in general (70%) and transparency vis-à-vis investors in particular (67%).

…in particular with regard to transparency and consumer protection

- Consumer protection in general (67%) and direct consumer protection issues in particular, *e.g.* related to hedge funds being marketed to a less wealthy clientele (63%).
- Financial stability (56%), and related to it: transparency of risk transfers/ultimate distribution of risks in the financial system (56%), as well as market liquidity in situation of distress (52%).
- By contrast, a majority of respondents (*i.e.* more than 70%) did not consider the role of hedge funds in pension fund investments to be a significant policy concern.

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Third, only few see a need for policy actions, but many the need for monitoring

Third, many respondents underlined the need for public authorities to monitor developments regarding hedge funds, but only a minority of countries are currently considering any new policies related to hedge funds (between 7 and 27% of respondents depending on the specific type of measure suggested).

Discussions at the CMF meeting

The most efficient way to address any policy concerns may be to focus on hedge fund investors and counterparties rather than on hedge funds themselves

Discussions at the CMF meeting suggested that a consensus is emerging that the most efficient way to address any policy concerns related to the activity of hedge funds is to focus on hedge fund investors and counterparties rather than on these entities themselves. Broad support was expressed by delegates for the suggested indirect policy approach of ensuring that prime brokers were adequately capitalised for their dealings with hedge funds, while relying on self regulation and voluntary codes of practice for hedge funds themselves.

As regards financial stability, several delegates expressed support for the assessment provided by the Financial Stability Forum

As regards financial stability, several delegates made explicit reference to ongoing work by the FSF, which focuses on the specific issue of financial stability. CMF delegates expressed support for the assessment provided in the update of the Financial Stability Forum (FSF) 2000 report on highly leveraged institutions, in particular for the suggested indirect policy approach of ensuring that systemically important hedge fund counterparties are adequately capitalised, while relying on self-regulation and voluntary codes of practice for hedge themselves.

Countries with high retail investment shares in hedge funds see more need for investor protection

As regards consumer protection, countries where exposure of retail investors to hedge fund investments and related financial products has increased (so-called retailisation) have generally underscored the need for investor protection. Retailisation includes arrangements whereby some mutual fund management companies offer hedge funds and/or use hedge-fund like techniques. It also includes the offer of notes linked to hedge fund performance by traditional financial intermediaries, which effectively grant retail investors exposure to hedge fund strategies. In this context, Committee members questioned whether structured financial products might entail greater risk as compared to hedge funds *per se*.

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The need for public authorities to continue monitoring hedge funds was reiterated

Only a minority of countries is considering policy actions in a variety of areas, but many delegates underlined the need for public authorities to continue monitoring developments regarding hedge funds, thus confirming the broad picture that emerged from the responses to the questionnaire.

I. How big is the hedge fund industry?

Definitional challenges

Comment: While the term "hedge fund industry" may convey the impression that these entities form a relatively homogeneous group, no two hedge funds are exactly the same and the differences among these investment vehicles are often more striking than their similarities.

It is hard to define the "typical" hedge fund that is offered for investment in OECD countries

Indeed, one of the findings from the CMF hedge fund questionnaire is that it is hard to define the "typical" hedge fund that is offered for investment in OECD countries. Hedge funds are sufficiently diverse that there is no commonly accepted definition of such entities at the international level. Even at national levels, there rarely exists a formal/legal definition of the term "hedge fund".[3] In many countries, there does not even exist a generally agreed definition (Figure 1).

Comment: Nevertheless, any meaningful international policy discussion of hedge funds needs to be based on a common definition for such entities. Agreeing on such a definition is complicated, however, for at least three reasons. First, hedge funds as a group are rather heterogeneous in terms of activities and investment strategies. Second, hedge funds share some common characteristics of other financial intermediaries, perhaps even increasingly so.[4] Third, the relevance of the first two points differs across countries.

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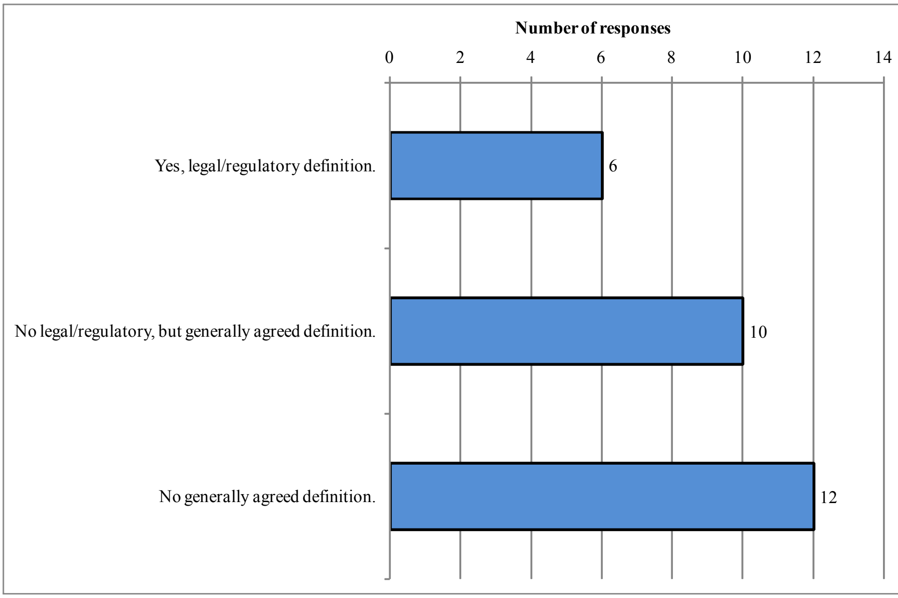
Figure 1. Answers to question: Is there a legal, regulatory, or otherwise generally agreed definition in your country of a hedge fund?



Note: 28 responses were obtained.

The variation in responses to the hedge fund questionnaire across respondents suggests there is disagreement on what are typical elements of hedge funds.

The use of alternative strategies such as short sales and leverage are seen as important elements of a hedge fund

Responses suggest that respondents consider the following aspects to be important elements of a hedge fund (Figure 2; note that multiple responses were allowed):

- The use of "alternative strategies (*e.g.* short sales, leverage, etc.)" is considered by almost all respondents as one of the more important features of hedge funds, according to the generally agreed definition in use in their country. Altogether 25 of 28 responses (*i.e.*,

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almost 90 per cent of respondents) identified this feature as a defining trait for hedge funds.

- A majority of respondents also considered "lighter investment rules" to be part of such core features (18 of 28, or 64 per cent).
- "High risk exposure" was considered by 60 per cent of respondents to be a defining characteristic of hedge funds.

Under "Other", some respondents noted the pursuit of absolute return strategies, the speed with which investors can withdraw their investments, and the tendency for hedge funds to be unregulated as important elements of a hedge fund definition.

Most consider hedge funds as variants of CIS rather than a separate investment category

Hedge funds are considered by most respondents as variants of collective investment schemes (CIS), rather than as a separate category of investments. One written comment received subsequent to the discussions noted in this context that hedge funds are *unregulated* CIS. But there were some dissenting views. For example, another written response suggested that it is not so crucial to determine what hedge funds are as it is to define what hedge funds are not; namely, they are *not similar* to other types of CIS.

Comment: In the United States there exist different definitions to describe hedge funds. Although the U.S. did not provide a detailed response to the CMF questionnaire, information is available from responses given to IOSCO (2006) by the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) of the United States. The SEC views the label "hedge funds" as referring specifically to CIS that are *not registered.* Thus, the SEC would not include registered CIS that engage in hedge fund-like strategies or registered funds of hedge funds in a definition of hedge funds. By contrast, according to views of the CFTC, there exist regulated entities which it would classify as hedge funds. The CFTC does not use the term "hedge fund" in its regulatory work, as it is not expressly defined in the Commodity Exchange Act (CEA) or the

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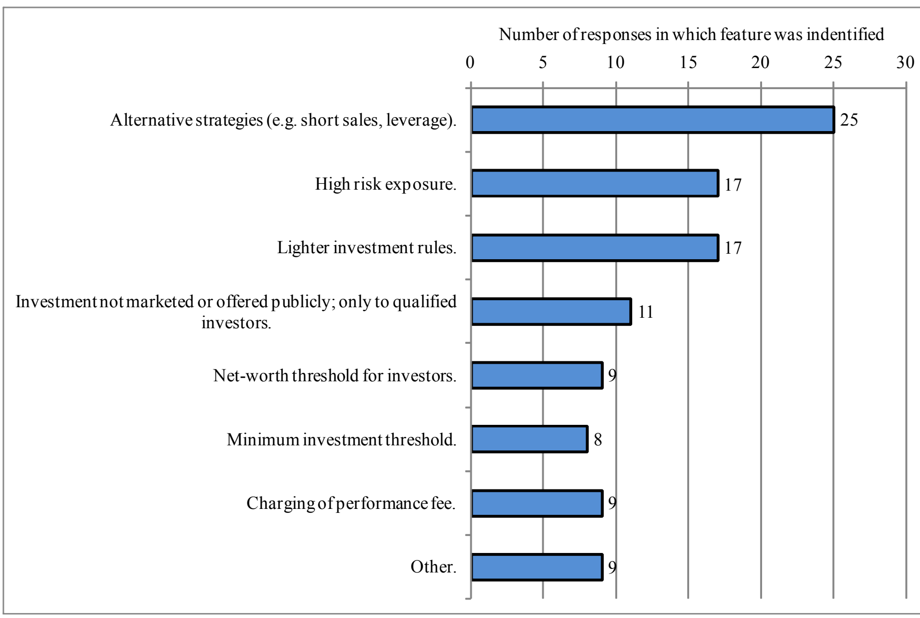
CFTC's own regulations. However, to the extent that a hedge fund or any other entity trades exchange-traded derivatives, that entity is considered for regulatory purposes to be a commodity pool (*i.e.* a collective investment vehicle that uses futures, options on futures, or commodity options traded on regulated futures exchanges), and its operator is subject to regulation under the CEA.

Figure 2. Answers to question: What feature(s) is (are) the most important one(s) used in the definition of hedge funds to distinguish them from other more traditional investment vehicles?



Note: 28 responses were obtained, with each response potentially mentioning multiple features.

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Assets under management by hedge funds offered in different OECD jurisdictions

Global AUM of hedge funds amount to roughly USD 1.5 trillion …

The database established using responses to the CMF hedge fund questionnaire and other (publicly available) information suggests that global assets under management (AUM) of hedge funds that are offered for investment amount to roughly USD 1.5 trillion. The data are shown in Table 1. As such, this total for AUM by hedge funds is about at the lower limit of estimates currently cited in the financial press.

Comment: As many hedge funds are exempt from regulation (see section V for a discussion) and as such are under no formal obligation to disclose detailed data, it is difficult to give precise estimates of the size of the hedge fund universe. The data shown in Table 1 refer to hedge funds *offered* for investment in each jurisdiction. Hedge funds offered for investment in a jurisdiction may or may not be registered or licensed in that jurisdiction. In fact, most hedge funds are not registered or licensed in the jurisdiction in which they are offered for investment.

…but estimates of the size of the global hedge fund universe vary considerably across different sources

Comment: Estimates of the size of the global hedge fund universe obtained from different sources vary considerably. According to estimates attributed to *Hedge Fund Intelligence*, global AUM by hedge funds exceeded USD two trillion at the beginning of 2007. These estimates are at the upper end of the spectrum of estimates. Indeed, at the time of this writing, estimates of the size of the hedge fund universe, including funds of funds, range from about USD 1.5 to 2.1 trillion.

The hedge fund industry is growing fast; indeed, faster than the mutual fund industry

Comment: Even the estimates that are at the lower end of the spectrum suggest fast growth of the industry (Figure 3). Indeed, AUM by hedge funds are growing faster than those under management by mutual funds. Even so, the total amount of AUM by hedge funds is still much smaller than the estimated USD 18 trillion of assets under management by the global mutual fund industry (according to estimates from the *Investment Company Institute*).

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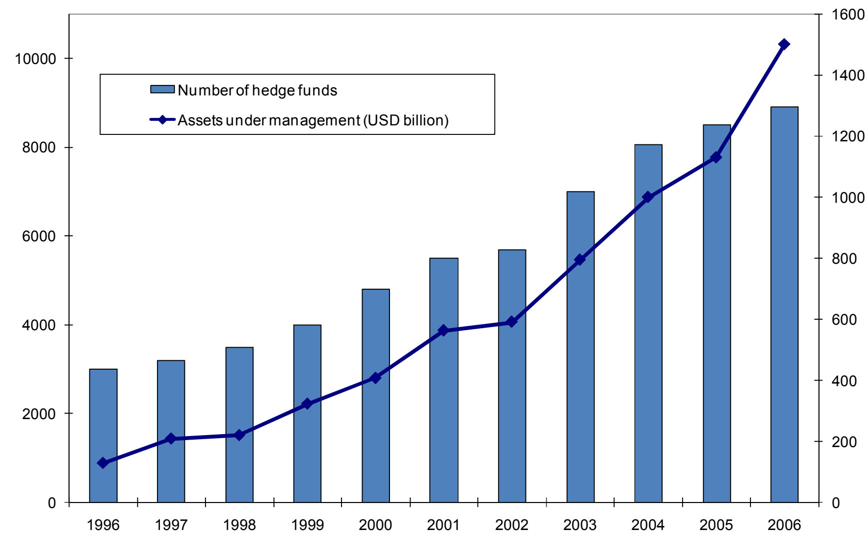
Figure 3. Growth of global hedge funds



Source: International Financial Services, "Hedge Funds", City Business Series, 16 April 2007.

Absolute size

The database established using responses to the CMF questionnaire reveals the following country-specific patterns (Figure 4):

The United States are by far the largest market in terms of hedge funds offered for investment ...

- The United States (data obtained from IOSCO, 2006) are a clear outlier in terms of absolute numbers. In that country, both the total number of hedge funds offered and AUM by these entities are much larger than the combined numbers and AUM of hedge funds that are offered in *all other* markets.

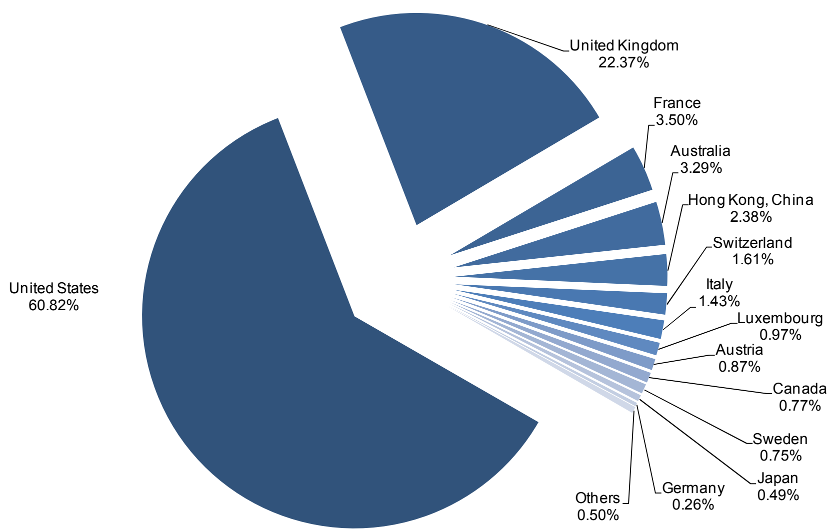
… followed by the United Kingdom

- On the basis of the same two size criteria (*i.e.* number of funds offered and AUM), the United Kingdom has the second largest hedge fund sector.

- The difference in size is also large between the market in the United Kingdom and the next-largest one, which is the one in France. Aligning the remaining markets in order of size, the differences between subsequent markets become more gradual.
- For all respondents, markets in which AUM by hedge funds exceed the equivalent of one billion USD are those of Australia, Austria, Canada, Finland, France, Germany, Hong Kong (China), Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, the United Kingdom and the United States.

Figure 4. Relative size of hedge fund sectors in different OECD countries

Assets under management by hedge funds offered for investment



Note: "Others" refers to the Netherlands, Finland, Poland, Portugal, Denmark and Spain. Percentages indicate shares of total assets under management identified by questionnaire responses and IOSCO (2006), as shown.

Source: CMF hedge fund questionnaire and IOSCO (2006).

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Table 1. Estimates of hedge funds offered in different jurisdictions

	Number of hedge funds offered	Assets under management (AUM) by HF offered
United States	7000	870.00
United Kingdom	850	320.00
France	360	50.00
Australia	260	47.00
Hong Kong (China)	305	34.05
Switzerland	254	23.10
Italy	204	15.60
Luxembourg	62	13.88
Austria	177	12.40
Canada	191	11.00
Sweden	50	10.80
Japan	231	7.00
Germany	48	3.65
Netherlands	40	3.00
Finland	20	2.70
Poland	5	1.00
Portugal	4	0.25
Denmark	3	0.19
Spain	5	0.02

Notes: Data comprises both single hedge funds and funds of hedge funds. Table shows only those countries for which actual data was reported in either the CMF or the IOSCO hedge fund questionnaire. Thus, the table excludes those countries where hedge funds are offered, but estimates of the number of funds and their assets under management are not available. Data shown is roughly as of mid-2006 (dates actually range from 2005 to the end of 2006).

Source: CMF hedge fund questionnaire and IOSCO (2006).

Relative size

Relative to domestic traditional investment vehicles, the (offshore) hedge fund sector is very large in the United Kingdom

- Relative to the size of the *domestic* mutual fund sector in each country (Table 1), the United Kingdom hedge fund sector (in terms of assets under management by funds offered for investment), stands out as the relatively largest sector. Note that hedge funds are domiciled *offshore*, while the mutual fund data refer to entities that are domiciled *onshore*.

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- According to this measure, the hedge fund sector is also relatively large in Australia, Austria, Finland, Hong Kong (China), Sweden, Switzerland, and the United States. AUM by hedge funds account for at least 5 per cent of AUM by mutual funds in these markets.[5]

Market clout of hedge funds

The market clout of hedge funds is more significant than the relative size of their balance sheets may suggest

Comment: One important observation regarding the role of hedge funds is that their market clout is more significant than the relative size of their balance sheets may suggest. Even though assets under control of hedge funds are still relatively small compared to other investment vehicles, these entities can be highly levered. Moreover, hedge funds typically trade more frequently than other more traditional investment vehicles. In addition, as hedge funds are not bound by regulatory restrictions regarding concentration of their investments, they can – and often do – specialise in trading specific types of securities.

Hedge funds have come to represent a sizeable share of total activity in many markets, and they can have relatively outsized importance in specific segments

Comment: As a result of these aspects of their trading strategy, hedge funds have come to represent a sizeable share of total activity in many markets, and they can have relatively outsized importance in specific markets segments. Often, the activity of hedge funds is relatively important in less standard and normally less liquid markets, although their activity may contribute to the liquidity of these markets. For example, hedge funds are estimated to have accounted for a very large share of total trading volumes in distressed debt and also for substantial volumes of trading in below-investment grade debt, emerging market bonds and leveraged loans, weather derivatives, and catastrophe bonds. Hedge funds are very active in the fast-growing market for credit derivatives, especially in higher-risk segments such as subordinated tranches of structured finance products. They are reportedly important sellers of credit protection and play a significant role in writing (relatively illiquid) deep out-of-the-money options. In many of the structured finance markets, some hedge funds now play a critical role in financing the least liquid tranches of transactions. More recently, the activity of hedge funds even in large and liquid markets such as the one for US Treasuries has received considerable attention.

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II. How risky are hedge fund activities perceived to be?

High risk exposure as a defining criterion for hedge funds

Tentative responses to this question can be derived from the responses to questions regarding defining criteria for hedge funds and related policy concerns. The following observations are singled out for special attention:

- A total of 17 respondents of the 28 respondent countries considered "high risk exposure" as a criterion distinguishing hedge funds from other more traditional investment vehicles.
- By contrast, 11 respondents did not consider "high risk exposure" as a distinguishing criterion.

"High risk exposure" is considered characteristic for hedge funds, mostly by continental European countries

Abstracting from these exceptions, one pattern that seems notable among the responses is the high incidence of continental European Countries, including the larger ones, among those who consider "high risk" as a typical characteristic of hedge funds, while Australia and the United Kingdom are among countries that do not consider this aspect as an integral characteristic of these entities.[6]

Policy issues that deserve particular attention

While some countries did not identify any issues that raise policy concerns…

Asked whether there are any significant policy concerns related to hedge fund activities, five respondent countries did not identify *any* issues that deserve particular attention by policymakers. With the exception of one respondent country, however, the hedge fund markets in these countries are insignificant according to the size criteria listed in Table 1.

… most respondents listed several issues that should deserve particular policy attention…

By contrast, most other respondent countries identified at least one issue they believe deserves particular attention by policymakers. Indeed, altogether 22 country responses cited at least one such issue (out of 27 responses, or some 82 per cent of answers to this specific question), and 19 countries listed four or more issues. One country's response did not provide any answer to this specific question.

Figure 5 shows the list of issues that were proposed in the CMF questionnaire and the number of times that each of these issues was identified by respondents to the CMF questionnaire as deserving particular attention.

… in particular transparency, especially vis-à-vis investors, and consumer protection

The figure illustrates that transparency generally, and transparency *vis-à-vis* investors, stands out as the most common concern amongst respondents (judged by the number of positive responses, *i.e.* ticked items). Consumer protection was the subject of the same high level of concern, which would be expected given that these two issues are closely linked.

Another major issue is financial stability with particular regard to risk distribution and market liquidity

The next greatest concern, though markedly less than transparency, is financial stability. General financial stability, transparency of risk transfers/ultimate distribution of risks in the financial system (and hence among hedge fund counterparties) and market liquidity in situations of distress are clearly signaled in the responses received as issues that bear watching.

There was less concern about the role of hedge funds in corporate governance…

There was less concern by respondents about the role of hedge funds in corporate governance among the responses to the questionnaire. A possible explanation for this finding is that hedge fund styles span such a wide spectrum and only a small fraction of hedge funds have been identified as being active in the market for corporate control and in seeking to influence corporate management decisions more generally. As well, respondents may appreciate the positive role that hedge funds may be playing in this respect, both directly and indirectly. Indeed, to the extent that hedge funds' activities improve market efficiency and the operation of price signals (*e.g.* by eliminating perceived price anomalies and being often more willing and able to take contrarian positions than other more traditional investment vehicles in situations of market distress), these entities may have a positive *indirect* effect on the governance of firms, facilitating the decision-making of other share- or stakeholders. Research by the OECD argues that these are on balance positive[7].

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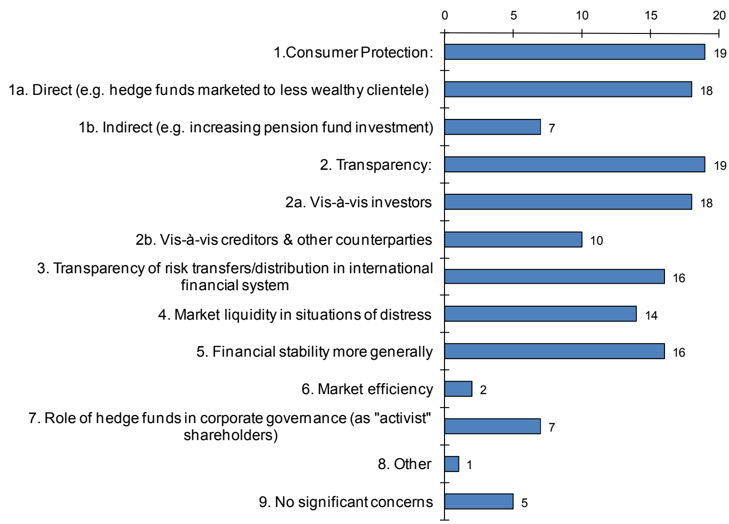
Figure 5. Policy issues related to the fast growth of hedge funds that deserve particular attention

Number of positive responses to question regarding issues raising policy concerns



Note: 27 responses were obtained, with each response potentially mentioning multiple features.

…and in pension fund investments

There also appears to be a general lack of concern about pension fund investments in these entities, even though such investments have the potential, at least, to expose consumers to hedge fund risks in an indirect way through their role as pension beneficiaries.

Only seven respondents considered pension fund investments in hedge funds to be an issue that deserves particular attention. There are no obvious patterns in these responses as regards the sizes of the hedge fund and pension fund sectors in respective respondent countries. Among the two countries with a large hedge fund sector that provided specific answers to this question, only France noted concerns regarding pension funds′ investments in hedge funds. Of countries with relatively large pension fund sectors, only Ireland expressed similar concerns.

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Comment: The general lack of concern may reflect respondents' views of pension fund managers as being sufficiently sophisticated to properly assess and manage the associated risk (adequacy of the trustee fiduciary role), or of investments in hedge funds as providing pension funds with diversification benefits (thus being risk reducing), or of the relative share of assets allocated to such investment vehicles by pension funds as being relatively small compared to the size of their overall balance sheets. Estimates of average pension fund exposures to hedge funds available for some OECD countries suggest that such exposures are typically below one per cent of total pension fund assets, although they could amount to three per cent in some countries (and to much higher percentages in the case of individual funds). Respondents may also have the view that pension funds are already adequately regulated, so that significant consumer protection concerns do not arise related to any type of specific pension fund investment. Finally, this situation may simply reflect the fact that respondents, which are from central banks, finance ministries, securities regulators, etc. and in most cases do not have direct pension fund supervisory responsibility, focus more on the systemic implications, which they may assess as limited.

Hedge funds are mostly seen as having enhanced the price discovery process and facilitated greater price efficiency

The impact of hedge funds on market efficiency was not considered an issue that deserves particular attention by policy makers, thus confirming the view CMF members expressed in the Committee's previous discussion related to hedge funds. According to that view, hedge funds have enhanced the price discovery process and facilitated greater price efficiency. They also have contributed importantly to the development and use of new products that have facilitated risk diversification within portfolios and the transfer of risk across portfolios.

Further to the issues listed as options in the questionnaire, one response identified market integrity as another issue that deserves particular attention by policy makers.

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III. How transparent are hedge funds?

Disclosure vis-à-vis investors

The responses to the questionnaire confirmed the usefulness of distinguishing between transparency *vis-à-vis* investors and *vis-à-vis* creditors and other counterparties.

Information provided by hedge funds to investors is considered to be at about the same level as information provided by other investment funds…

As regards transparency *vis-à-vis* investors, altogether twelve respondent countries noted that the information provided by hedge funds is about the same as that provided by other investment funds. One response commented that hedge funds licensed in the country have to provide exactly the same information as all other undertakings for collective investments.

One response noted that a key difference between disclosure by hedge funds and disclosure by investment funds regulated for retail sale is that the latter is governed by specific legislation, while the information hedge funds disclose to their investors is to a large extent governed by negotiation between investors and the manager. Hedge fund managers are generally under pressure to provide a high level of disclosure in order to satisfy investor demand, but in some circumstances are also keen to preserve confidentiality of certain information where that is important to their investment strategy. The actual level of disclosure depends on the outcome of such negotiations and varies from fund to fund. Thus, it is difficult to generalise. The response also noted that hedge fund managers in the country are also subject to some specific disclosure requirements (*e.g.* existence of side letters with "material" terms must be disclosed).

…but some shortcomings were identified

By contrast, five responses expressed the view that hedge funds provide less information as compared to information provided by other investment funds.

- According to these responses, hedge funds provide less information related to returns, strategies/investment policies, and specific individual asset allocations than do other types of investment funds. Some responses also noted that hedge funds need not (and actually do not) provide information as frequently as other investment funds.

Progress in disclosure was noted, however

- In almost all cases where respondents identified such shortfalls in disclosure, they also noted that the market has made progress in increasing transparency. Progress in disclosure was also noted by respondents that considered the information provided by hedge funds to be about the same as compared to that provided by other investment funds.

- As to the driving forces behind progress in improving disclosure, many respondents described the process as market-driven. One example relates to the increasingly important role of institutional investors as sources of capital for hedge funds. These investors have a fiduciary responsibility to prudently evaluate the strategies and risk management capabilities of the collective investment schemes in which they invest and to ensure that the risk profiles of these entities are suitable for their own clients and beneficiaries. They tend, therefore, to be more demanding typically with respect to disclosure than are retail investors. The increased participation of institutions in hedge fund investments may have prompted improvements in disclosure *vis-à-vis* investors more generally.

- One response noted however that, in the case of that country, progress was not primarily market-driven, but reflected specific changes in regulation.

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Greater transparency was considered important, but how to achieve it remained an open question

Comment: This progress in hedge fund disclosure notwithstanding, discussions within the last *Tour d'Horizon on Financial Markets* suggested that a consensus is emerging that greater transparency could play an important role in further reducing potential threats to consumer protection that may be associated with the growing role of that industry. But how to enhance transparency remained an open question.

Disclosure vis-à-vis creditors and other counterparties

Comment: Past CMF discussions suggest that disclosure *vis-à-vis* creditors and other counterparties is a crucial parameter related to the potential financial stability risks emanating from hedge funds. The capacity of the latter to affect systemic stability adversely is a function of their transactions with regulated systemically important financial intermediaries. Supervisors of the latter attempt to ensure that there are appropriate controls in place at these institutions and that they obtain adequate information from hedge funds.

Two responses stressed that it is the responsibility of banks and other counterparties to ensure they have sufficient information on hedge funds (as for any other counterparty) before entering into a transaction with them. Authorities in these countries expect banks to have appropriate risk management processes in place, which include obtaining sufficient information on counterparties and borrowers. If the counterparties cannot acquire sufficient information to assess and manage their exposure to hedge funds, they should reduce or eliminate their exposure. Banking supervision should ensure that these principles are applied in the case of each individual financial institution.

Hedge funds were generally considered to provide about the same information vis-à-vis counterparties as do other market participants …

Respondents from twelve countries indicated that hedge funds operating in their countries generally provide about the same type and quality of information *vis-à-vis* creditors and other counterparties as do other market participants in similar transactions.

… but some countries suggested that hedge funds provide less information

By contrast, four respondent countries noted that hedge funds operating in their countries provide less information than other market participants in similar transactions (*e.g.* regarding strategies/investment policies, risk profiles, confirmation that proposed strategy was effectively executed, degree of leverage, specific portfolio composition etc.). In this context, some respondents note that there exist barriers that prevent counterparties of hedge funds from achieving greater transparency due to existing competitive pressures. The remaining respondent countries noted that the question was either not applicable in their case or that they did not know the answer.

Comment: Past CMF discussions suggest that, similar to the issue of disclosure *vis-à-vis* investors, a consensus seems to be emerging that greater transparency could play an important role in reducing potential threats to financial stability that may be associated with the growing role of the hedge fund industry. But how to enhance such disclosure remains an open question, although several proposals have been put forth.

The questionnaire listed several of the proposals that have been made and that may have either a direct or an indirect effect on hedge funds. Unfortunately the responses were uneven, making it difficult to identify clear patterns regarding preferences for any particular set of measures.

Responses suggested that there is support for private sector initiatives to enhance transparency of the hedge fund sector

This being said, questionnaire responses suggested that there is support for an “enhanced dialogue with the private sector to identify appropriate roles of private and public sectors and greater support of private sector initiatives” to enhance transparency of the hedge fund sector, such as the Counterparty Risk Management Group. Four respondents noted that related measures are currently being implemented, while another seven respondents noted that such measures are currently being considered (although four respondents did not consider them helpful).

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IV. How protected are investors?

Can hedge fund investments be offered to retail investors?

In some countries, hedge funds cannot be offered for investment neither to individuals nor to institutions

In most countries, hedge funds can be offered to both individuals and institutional investors. In one respondent country, however, hedge funds can be offered to institutional investors only. In five respondent countries, investor protection appears to be particularly strong, as hedge funds can neither be offered to individuals nor to institutions.

Under which circumstances can hedge fund investments be offered to retail investors?

If hedge funds can be offered to retail investors, several restrictions apply

In countries where hedge funds can be offered to retail investors, restrictions apply to the way they can be offered. These restrictions typically limit the types of investors who can access hedge fund investments without triggering more general investor protection rules. These restrictions differ from country to country and they can also change over time.

In some countries, there exist minimum initial investments for direct investments in hedge funds by retail investors. The levels of minimum initial investment thresholds differ considerably across countries. For example, they are high in Australia (AUD 500000), but considerably lower in many, but not all, Continental European countries (often Euro 50000). In some jurisdictions, the thresholds depend on the type of hedge fund. In France, the minimum investment levels also depend on the net wealth of the individual. There are also minimum levels of net wealth required for individual investors to be able to invest in hedge funds in some countries, the amount of which differs across countries. In some countries, hedge funds cannot be offered to the *general public*.

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V. How directly regulated are or should hedge funds be?

Regulatory frameworks related to hedge funds

Direct regulation could apply to the hedge fund itself or to the hedge fund manager/advisor. The questionnaire did not make this distinction explicit and the results discussed in the following paragraphs should be viewed in this context. In this context, note that hedge funds in the United Kingdom are lightly regulated and are typically domiciled offshore, but that the managers/advisors and their activity are regulated in that jurisdiction.

There are considerable differences in regulatory frameworks related to hedge funds in OECD countries

There are considerable differences in regulatory frameworks relating to hedge funds in OECD countries. In some countries hedge funds are regulated just like other collective investment schemes, while in other countries specific regulations apply to the former. In some, hedge funds are directly regulated; in others hedge fund advisors/managers are. Various jurisdictions regulate the distribution of hedge funds, and/or the information that the hedge funds provide to customers. There are also differences in the requirements for retail hedge fund disclosure documents and reporting. Regulatory requirements for such retail hedge funds can differ from those for other regulated investment companies and, in some jurisdictions, they also differ between different types of retail hedge funds, such as between single hedge funds and funds of hedge funds.

There exist specific registration/licensing requirements covering either hedge funds themselves or their advisors in most OECD jurisdictions

There exist specific licensing and/or registration requirements covering either hedge funds themselves or hedge fund advisers in most OECD jurisdictions. In most respondent countries, hedge funds and/or related entities such as managers/advisors are required to be licensed (in 19 of 27 countries that responded to this specific question) or registered (in 11 of 27 respondent countries) for the hedge fund to be offered in those jurisdictions. Some countries are currently considering measures related to registration (6 respondent countries) or licensing (4 respondent countries).

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Comment 1: On an international level, the policy dialogue is intensifying, including in fora such as the FSF and IOSCO (see also Table 2). While there are many different opinions, the preponderance of views lies more in the direction that risks associated with hedge funds are best dealt with via self-regulation by the industry: policy needs to strike the right balance between hedge funds need to operate freely and the desires of policy makers for transparency, surveillance and sound investor protection.

Even if hedge funds are not directly regulated, they do not operate in a regulatory vacuum, as they interact with other regulated institutions

Comment 2: Even if hedge funds *themselves* are not directly regulated, they do not operate in a regulatory vacuum. For one, as in the case of other types of asset managers, enforcement agencies have broad regulatory authority on matters such as fraud, manipulation, civil liability and other aspects of market behaviour. Moreover, to the extent that hedge funds trade on regulated exchanges, they are subject to market conduct regulation. Finally, they deal and interact with other regulated institutions and these counterparties are explicitly monitored and supervised by regulators.

Few policy measures considered except one, i.e. continued monitoring

A minority of countries are considering policy actions in a variety of areas. This includes an enhanced role for rating agencies, enhanced dialogue with the private sector, improving market infrastructure, policies targeting both individual investors and institutional investors.

Comment: Overall, the number of countries considering specific regulatory measures is limited. To the extent that such measures are not implemented on a global level, but implemented only in specific countries, there may be adverse effects on the hedge fund sectors in the countries, thus potentially limiting the positive role that such entities may play in financial markets.

Many respondents underlined the need for policy makers to monitor developments regarding hedge funds

Many respondents seem to underline the need for public authorities to continue monitoring developments regarding hedge funds. According to 17 respondent countries, information regarding hedge funds should be regularly collected by public authorities to facilitate the

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monitoring of the hedge fund sector (11 respondents suggesting that this be carried out on a mandatory basis), although many respondents explicitly stated that information should be collected through regulated counterparties of hedge funds rather than through hedge funds themselves.

Table 2. Major initiatives of international organisations related to hedge funds

January 1999	Basel Committee on Banking Supervision, Banks' Interactions with Highly Leveraged Institutions (HLIs)
January 1999	Basel Committee on Banking Supervision, Sound Practices for Banks' Interactions with HLIs
June 1999	Counterparty Risk Management Policy Group I, Improving Counterparty Risk Management Practices
November 1999	International Organization of Securities Commissions, Report on Hedge Funds and Other HLIs
January 2000	Basel Committee on Banking Supervision, Banks' Interactions with HLIs: Implementation of the Basel Committee's Sound Practices Paper
April 2000	Financial Stability Forum, Report of the Working Group on HLIs
March 2001	Basel Committee on Banking Supervision/International Organization of Securities Commissions, "Review of issues relating to HLIs"
August 2002	Alternative Investment Management Association, Guide to Sound Practices for European Hedge Fund Managers
February 2003	International Organization of Securities Commissions, Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds
July 2005	Counterparty Risk Management Policy Group II, Toward Greater Financial Stability: A Private Sector Perspective
August 2005	Managed Funds Association, Sound Practices for Hedge Fund Managers (update of the practice papers of 2000 and 2003)
March 2007	IOSCO releases for public comment draft principles on disclosure and especially valuation issues.
March 2007	Alternative Investment Management Association issues a new Guide to Sound Practices for Hedge Fund Valuation.
April 2007	Alternative Investment Management Association issued a revised set of due diligence questionnaires for use by those investing in or servicing the hedge fund industry.
April 2007	Update of the Financial Stability Forum's "Report of the Working Group on HLIs"
October 2007	Hedge Fund Working Group, consisting of hedge fund representatives, announced that the Group is working on establishing standard practices for disclosure and behaviour of hedge funds (with the final report to be published in early 2008).

Source: ECB, *Monthly Bulletin*, January 2006 and own additions.

VI. Discussions at the CMF meeting

To focus on hedge fund investors and counterparties was seen as most efficient to address concerns related to hedge funds

CMF delegates agreed with the notion that hedge fund activities have many positive aspects, but some of them also noted that despite the overall beneficial role of hedge funds, there are several specific policy concerns, such as those related to financial stability and investor protection. Calls for hedge fund regulation have to be seen against the background of these concerns. Having

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said that, a consensus may be emerging that the most efficient way to address these concerns is to focus on hedge fund investors and counterparties rather than on these entities themselves. One should not forget that even if hedge funds are not always directly tightly regulated, they do not operate in a regulatory vacuum.

Several delegates noted that one issue is that, while trading activity of hedge funds may reduce volatility during normal times, it is less clear that hedge funds would behave the same during times of market stress. This issue is not limited to hedge funds alone, however, as pointed out by a delegate. Proprietary trading desks in banks may also contribute to increased volatility in some instances, particularly during periods of stress.

One delegate suggested that another specific risk related to financial stability is that second-tier banks are currently getting into the hedge fund business, and these institutions may not fully appreciate the risks associated with their dealings with hedge funds.

A specific issue that is relevant for investor protection, as well as for financial stability, is that of hedge fund asset valuation. Investor protection is facilitated by the use of transparent and consistent asset valuation methods. It is also important to ensure that different investors in hedge funds are treated equally by these entities.

There was broad support for the indirect policy approach of ensuring adequate capitalisation of prime brokers, while relying on self regulation of hedge funds

As regards policy responses, especially those related to financial stability issues, several delegates made explicit reference to ongoing work by the FSF (the update of their 2000 report on highly leveraged institutions) and expressed support for the assessment provided in that report regarding financial stability issues and related policies. In particular, broad support was expressed by these delegates for the suggested indirect policy approach of ensuring that prime brokers were adequately capitalised for their dealings with hedge funds, while relying on self regulation and voluntary codes of practice for hedge funds themselves.

One delegate suggested that countries with greater global hedge fund trading activity, such as the United States and the United Kingdom, have sought to maintain

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hedge funds' potential for positive contributions to market efficiency, while ensuring that hedge fund failures would not jeopardise the safety and soundness of systemically important regulated counterparties (*i.e.* banks and broker-dealers). The regulators in these countries tend to focus on counterparty risk management and efforts to monitor hedge fund indirectly. For greatest effectiveness, such an approach would benefit significantly from increased cooperation and dialogue among regulators, which has been evident in recent months.

It was also noted that countries where retail investors' exposure to hedge fund investments and related financial products has increased have generally underscored the need for investor protection.

Registered hedge funds are usually subject to disclosure rules aimed at informing investors of the risks associated with hedge fund investments. Regulatory standards for eligible investors attempt to limit retail investor participation to those considered sufficiently informed to assess the risk profile and/or wealthy enough to retain advisors or sustain the potential losses. Over time, asset price inflation (including real estate prices) has eroded some of the nominal wealth and income eligibility criteria designed to limit the size of the eligible investor group, and some authorities have acted to restore their relevance.

Voluntary codes of conduct and best practices have been proposed previously by the industry…

Industry reactions to calls for increased collaboration between the private sector (*i.e.* hedge funds, banks and brokers) and the supervisory community have been generally positive. The largest hedge funds today generally recognize the need to further improve transparency and public-sector understanding of their activities. Many express a willingness to provide financial information to supervisory authorities to help improve financial stability analysis and greater understanding of hedge fund activities.

…but they have not gained broad acceptance so far

However, while voluntary codes of conduct and best practices have been proposed previously by the industry, it was noted, they have not gained broad acceptance so far.

Comment: Note that the London-based Hedge Fund Working Group, consisting of representatives from many of the world largest hedge funds, announced in October 2007 that the Group is working on establishing standard practices for disclosure and behaviour of the hedge fund industry. The code to be drafted is intended to serve as a framework for eventual global standards. A final report with details on that code was expected to be published in early 2008.

The relevant type of data required from hedge funds need to be identified

The essence of several delegates' remarks were consistent with the view that requiring data from hedge funds directly faces the difficult challenge that the relevant type of data needs to be identified. In addition, it is important to ensure that the data be received with little time lag. Given the active investment style of many hedge funds, disclosures of some information may be either impractical or of limited value. Experiences with reporting requirements for hedge funds in Sweden have highlighted the need for timely information. Delegates broadly accepted the view that in a crisis situation demanding more information would be neither practical nor useful.

Indirect supervision through regulated institutions is seen as sufficient to deal with the possible threats emanating from hedge funds

Delegates noted that hedge funds are risk-takers and that they promote innovation. Industry observers and participants generally agree that hedge funds have played a very constructive role and that any new initiatives related to hedge fund oversight should seek to preserve this role. Costs associated with new requirements, such as reporting systems, need to be carefully weighed against the likely benefits. These costs may drive some funds from the market as well as deter others from entering it, at the possible costs of reduced competition, innovation, market liquidity, and risk dispersion. One should also not forget that hedge funds have a legitimate business interest in safeguarding some information to avoid the risk of "front running" by counterparties and competitors.

Concluding, hedge funds per se are not presenting much of a risk at this moment

Concluding, hedge funds' portfolios are not presenting much of a risk at this moment. This view is consistent with the findings from the questionnaire that only a minority of countries is considering policy actions in a variety of areas, and that the number of countries considering specific direct regulatory measures focusing on hedge funds is limited.

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Notes

1. Large losses at one large hedge fund (Amaranth) just prior to the meeting in November 2006 made that discussion within the *Tour d'Horizon* on Financial Markets (TDH) particularly timely. The Committee decided to review the issue of the growing role of hedge funds in financial markets and related policy concerns more generally within the subsequent TDH at the Committee's meeting in May 2007. The Committee asked the Secretariat to circulate a questionnaire on hedge funds and summarise the results in a note for the new round of discussions in May 2007. The present article builds on the note summarising the questionnaire responses. The results were also made available to the Insurance and Private Pensions Committee (IPPC) and its Working Party on Private Pensions (WPPP) and presented at the meetings of that Committee and its Working Party July 2007. The results of Earlier CMF discussions of hedge funds and the broad structure of the CMF hedge fund questionnaire were already presented at the IPPC meeting in December 2006. At that meeting, the IPPC decided to circulate its own questionnaires (one each on hedge funds and insurance markets and another one on hedge funds and private pension funds), and the Secretariat coordinated the contents of the CMF questionnaire with those of the IPPC and the WPPP. Results regarding the responses to the IPPC and WPPP questionnaires have become available since the CMF discussion of the issue in May 2007.

2. The percentages cited here and below are calculated based on the total number of responses to the specific questions concerned. Multiple answers were possible.

3. Note that the first of four conclusions drawn from the responses to a recent International Organisation of Securities Commissions (IOSCO) 2006 questionnaire on the regulatory environment for hedge funds was that none of the responding members had adopted a formal/legal definition of the term "hedge fund". That being said, some respondents to the CMF hedge fund questionnaire now noted that there exists a legal/regulatory definition of the term "hedge fund" in their countries. The CMF questionnaire did not ask respondents to provide explicit definitions, however.

4. For example, traditional fund managers seem to increasingly think that they need to either offer hedge funds themselves or adopt some of the investment strategies pursued by hedge funds. In this context, one respondent noted that the most recent update to the EU directives on Undertakings for Collective Investments in Transferable Securities (UCITS, *i.e.* EU retail investment funds) gives managers of these investment funds greater freedom to use derivatives and related innovative investment strategies. Some funds have started to exploit these new freedoms by employing more complex investment strategies that in some cases draw on elements from the approaches of hedge funds.

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5. In terms of GDP, hedge fund sectors are relatively large in Australia, Luxembourg, the United Kingdom, the United States and Switzerland, with total AUM of hedge funds offered exceeding 5 per cent of domestic GDP (although it is not so clear whether GDP is a useful reference for the sample at hand).

6. The issue of risk related to hedge funds is taken up in Blundell-Wignall, A. "An Overview of Hedge Funds and Structured Products: Issues in Leverage and Risk", OECD *Financial Market Trends* Vol 2007/1, No. 92.

7. The Implications of Alternative Investment Vehicles for Corporate Governance, http://www.oecd.org/dataoecd/60/11/39007051.pdf

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