UNIVERSITY OF PIRAEUS

DEPARTMENT OF BANKING & FINANCIAL MANAGEMENT

GRADUATE PROGRAMME IN FINANCIAL ANALYSIS FOR EXECUTIVES

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DISSERTATION:

HEDGE FUNDS AND PRIVATE EQUITIES: REGULATE OR NOT?

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JUNE 2009

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INTRODUCTION

The debate about the role of hedge funds regulation started some ten years ago. It is based on spectacular failures that threatened financial stability, like the near collapse of LTCM (1998) or the bankruptcy of Amaranth (2006).[1] The credit crisis that has embroiled US and global financial markets since the summer of 2007 has created a number of casualties, most notably three of the top five US investment banks (Bear Stearns, Lehman Brothers, and Merrill Lynch). In hindsight their highly leveraged business model was particularly vulnerable to deterioration in market and funding liquidity.[2] This subprime crisis has revealed the weaknesses and the risks of securitization, in which the hedge funds industry has been deeply involved. This latest event bolsters the debate about the risks embedded in hedge funds. Pleas for stronger regulation are getting more attention. [3]

At the same time, it is striking how few hedge funds have suffered the same fate. A widely held view following the collapse of long-term capital management (LTCM) was that hedge funds – as highly leveraged institutions – pose a systemic risk to the global financial system. This view motivated the global financial architecture to push for greater direct regulation of hedge funds—a call that has been repeated in discussions. [4]

A specific allegation against hedge funds that has stuck is their practice of short selling of stocks. It is claimed that short selling, especially of financial stocks, led to large falls in prices, created “disorderly markets” and caused further instability in the financial sector.[5] Moreover, several countries have prohibited the short selling of shares, which has had a negative effect on the funds’ arbitrage strategies.

Hedge funds have generally coped well in times of financial crisis. The discussion about hedge funds and financial crises has nevertheless arisen once again during the current period of turbulence on the financial markets. The question is: What has the role of the hedge funds been in the current crisis so far? To simplify somewhat, we can say that the hedge funds have been affected more by the present financial crisis

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[1] M.Aglietta, S.Rigot, “The regulation of hedge funds under the prism of the financial crisis” (Univesite Paris X-Nanterre 2008/20), available at <http://economix.u-paris10.fr/>, page 2.

[2] M.Kinga, P.Maier , ‘Hedge funds and financial stability: Regulating prime brokers will mitigate systemic risks’,Journal of Financial Stability (2009), available at <http://www.elsevier.com/locate/jfstabil > ,pages 1-2.

[3] M.Aglietta, S.Rigot, page 2.

[4] M.Kinga, P.Maier, page 2.

[5]https://www.financialworld.co.uk/Archive/2009/2009_03mar/Features/hedge_funds/16134.cf Hedge funds under attack, March 2009

than they have affected it. The main argument for this is that hedge funds have experienced more problems in handling this crisis than previous financial crises.[6]

Key characteristics of the hedge fund industry are reviewed, and prominent hedge fund failures draw lessons in order to identify conditions under which this sector can pose a risk to the global financial system. It is argued that direct regulation of hedge funds that increases transparency –whether of counterparty exposures or trading positions – does not appear feasible and may create a moral-hazard problem. It may also make the financial system less resilient by reducing the willingness of hedge funds to act as liquidity providers in times of crisis. It is also argued that market discipline is effective in leading hedge funds to limit their leverage and manage their exposures.

On the other hand, institutional investors are demanding greater transparency, while investment by managers in their own fund mitigates principal-agent problems and ensures that managers react quickly to market fluctuations. Regulators should instead increase the regulation of hedge fund counterparties and ensure – through the use of collateral and haircuts – that the losses from a hedge fund collapse remain with the fund's investors.

An efficient, yet stable, financial system should not prevent a hedge fund failure *per se*. Instead, it should limit the transmission of a hedge fund failure to the broader financial system. Indirect regulation is not eroded by the practice of large hedge funds using multiple prime brokers. Given the degree of concentration in the prime brokerage business, we argue that it is prudent for a large hedge fund to diversify its exposure to a single counterparty. Regulation of LCFIs should ensure that prime brokers maintain rigorous risk management practices, such as holding adequate collateral with suitable haircuts. Both tools may be eroded through competition to attract valuable hedge fund business, increasing the vulnerability of the prime broker to a hedge fund collapse. Regulation should address this potential market failure. As the current credit crisis has shown, the collapse of an LCFI is more likely to pose a threat to financial stability, as seen in the case of Lehman Brothers.[7]

The joint statement issued in London by the leaders of the Group of 20 on the first days of April 2009 expressed a commitment to bring "all systemically important financial institutions" within the purview of their respective financial regulatory and oversight regimes. Notably, the statement singled out hedge funds for additional regulation, but made no mention of whether private equity funds would also be

[6] M. Strömqvist, "Hedge funds and the financial crisis of 2008 no. 3", March 25,2009, available at <http://www.riksbank.com/templates/Page.aspx?id=31090>
[7] M. Kinga, P. Maier , page 1-2

subject to greater scrutiny by financial authorities. A week after the breakup of the G-20 meeting, it appears that elected officials and members of the investment community in Europe remain divided as to whether private equity funds warrant increased regulation.

The *Financial Times* reported that the European Commission announced a one-week delay in the issuance of its highly anticipated proposals for new regulations governing hedge funds and private equity funds. Although European Commission representatives attributed the postponement to a bureaucratic bottleneck, the *Financial Times* suggested rumors were a foot that leaked drafts of the Commission's proposed legislation provoked disapproval by some European government ministers and members of the private equity community.

Across the Channel, the *Wall Street Journal* reports that both U.K.'s financial regulator, the Financial Services Authority (FSA), and the British Treasury Ministry have expressed less interest in tightening regulation of private equity funds than their Continental counterparts. British officials' more *laissez-faire* attitude towards private equity seems to stem from their conclusion that private equity funds are not "too big to fail."

Of course, it's still too early to tell how these legislative proposals will shake out in the end. But at this stage, one thing seems clear: the decision whether private equity funds should be more strictly regulated will most likely turn on public officials' assessment of the likelihood that the collapse of a large private equity fund or the insolvencies of multiple portfolio companies would result in unacceptable externalities.[8]

ΠΑΝΕΠΙΣΤΗΜΙΟ ΠΕΙΡΑΙΑ

PART I - DEFINITIONS OF HEDGE FUNDS & PRIVATE EQUITIES

[8] G.Parnass, "European Regulators Eye Private Equity", 10 April 2009, available at <www.privateequitylawreview.com/tags/hedge-fund/>

A. HEDGE FUNDS

1. Hedge Fund Structure

What is a hedge fund? Given their diverse investment strategies, varied investment horizons, assorted sizes and areas of expertise, this is a surprisingly difficult question to answer. The few commonalities of hedge funds are their structure and their payment schemes. In domestic form these funds are typically structured as private partnerships; offshore, as private Cayman corporations. Investors range from wealthy individuals and charitable endowments to pension funds and sovereign states. Hedge fund managers are charitable typically paid a fixed fee (1%-2% of assets under management) and a cut of the profits (typically 20%) every year.[9]

A hedge fund is a vehicle for holding and investing the funds of its investors.[10] Hedge funds typically offer their investors liquidity access following an initial "lock-up" period, which is typically for less than two years.[11] Hedge funds are generally privately-owned investment funds, and so are not regulated.[12]

2. Domicile

The specific legal structure of a hedge fund – in particular its domicile and the type of legal entity used – is usually determined by the tax environment of the fund's expected investors. Regulatory considerations will also play a role. Many hedge funds are established in offshore tax havens so that the fund can avoid paying tax on the increase in the value of its portfolio. An investor will still pay tax on any profit he makes when he realizes its investment, and the investment manager, usually based in a major financial centre, will pay tax on the fees that he receives for managing the fund.

At end-2007, 52% of the number of hedge funds were registered offshore. The most popular offshore location was the Cayman Islands (57% of number of offshore funds), followed by British Virgin Islands (16%) and Bermuda (11%). The other offshore centers are the Isle of Man and Mauritius. The US was the most popular

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[9] J. Ballabon (President of the Ballabon Group LLC, a government relations and crisis management firm in New York and Washington, DC.), June 2008, available at <http://library.findlaw.com/2008/Jun/1/247212.html>

[10] "Hedge Fund", 18 January 2009 available at <http://en.wikipedia.org/wiki/hedge>.

[11] SECURITIES AND EXCHANGE COMMISSION, Release No. IA-2333; File No. S7-30-04, Registration Under the Advisers Act of Certain Hedge Fund Advisers (2004) p.38, available at <www.sec.gov>.

[12] "What are Hedge funds?" available at <http://useconomy.about.com/od/themarkets/f/hedge_funds.htm>

onshore location (with funds mostly registered in Delaware) accounting for 65% of the number of onshore funds, followed by Europe with 31%.

3. Hedge Funds Managers

The portfolio of the hedge fund is managed by the hedge fund manager, which is the actual business and has employees. Saying a person works at a hedge fund is not technically correct, they work at the hedge fund manager.[13]

Criticized for making too much money and the occasional fantastic flame-out, there is little sympathy for hedge fund managers. Often depicted by the media as "murky" or "secretive" unregulated pools of capital, suspicion of these investment vehicles abounds.[14]

Hedge fund managers are compensated as a percent of the returns they earn. This attracts many investors who are frustrated by mutual fund fees that are paid regardless of fund performance. Thanks to this compensation structure, hedge fund managers are driven to achieve above market returns. Since they get zero no matter how much money they lose, they are also very risk tolerant. This makes the funds very risky for the investor, who can lose much more than zero.

Hedge fund managers are very good at using sophisticated derivatives, such as futures contracts, options and puts. Basically, these products all do two things: they use small amounts of money, or leverage, to promise large amounts of stocks or commodities. Secondly, they all say they will deliver this stock or commodity at a particular point in time. In that sense, hedge fund managers are trying to time the market, which some would say is very difficult if not impossible to do.[15] Managers of hedge funds do not make public solicitations to investors in general and as such do not face the public reporting requirements that their mutual fund counterparts do.

[13] "Hedge Fund", 18 January 2009 available at <http://en.wikipedia.org/wiki/hedge>.
[14] J. Ballabon
[15] "What are Hedge funds?" available at <http://useconomy.about.com/od/themarkets/f/hedge_funds.htm>

4. Hedge Funds Investors

Hedge funds were developed as an alternative to openend investment funds or mutual funds.[16] The fund itself has no employees and no assets other than its investment portfolio and cash, while its investors are its clients.[17]

Hedge funds are typically open only to a limited range of professional or wealthy investors. This provides them with an exemption in many jurisdictions from regulations governing short selling, derivative contracts, leverage, fee structures and the liquidity of interests in the fund. A hedge fund will typically commit itself to a particular investment strategy, investment types and leverage levels via statements in its offering documentation, thereby giving investors some indication of the nature of the fund.[18]

As mentioned previously, hedge funds raise capital from institutional investors and wealthy individuals. Smaller investors are kept out by the large initial investment requirements, combined with the fact that only a limited number of investors are invited to participate. Since hedge funds do not face as great reporting requirements, investors have more limited access to return data. When returns are high, investors may not care as much about reporting, but when returns fall below expectations, investors often want a more complete explanation for the disappointing results.
During the early 1990s, hedge funds used to be able to be more selective of the investors they accepted for their funds. The management of some funds had an attitude that they would consider who they wanted to allow to invest in their fund and those investors should be happy with the returns they enjoyed and accept whatever meager disclosure they were given. If they did not like it, they could be replaced by a long line of investors wanting to take their place. This began to change due to a couple of factors. One was the catastrophic failure of Long Term Capital Management, a firm made popular by the claims that it managed money using the expertise of Nobel Prize–winning economists Merton Miller and Myron Scholes. Their expertise did not prevent the fund, which was founded in 1994, from collapsing following the 1998 Russian bond default. The collapse of the fund, which lost $2 billion in one month (20 percent of its capital), almost brought down many major financial institutions that had lent substantial amounts of money to the fund. The

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[16] P.Gaughan, "How Private Equity and Hedge Funds Are Driving M&A", Wiley Periodicals, Inc (2007), p.59

[17] "Hedge Fund", 18 January 2009, available at <http://en.wikipedia.org/wiki/hedge>.

[18] M.Kinga, P.Maier , page 1-2

disaster was solved through the intervention of Federal Reserve Chairman Alan Greenspan. Following the failure of Long Term Capital Management, investors began to look more closely at their hedge fund investments. At the same time, however, the growth and proliferation of hedge funds in the 1990s and 2000s continued relatively unabated.

5. Hedge funds strategies

As the name implies, hedge funds often seek to offset potential losses in the principal markets they invest in by hedging their investments using a variety of methods, most notably short selling. However, the term "hedge fund" has come to be applied to many funds that do not actually hedge their investments, and in particular to funds using short selling and other "hedging" methods to increase rather than reduce risk, with the expectation of increasing return.[19] These aggressive investment methods include short selling, swaps, arbitrage, and employing leverage to increase return potential. [20]

Each fund will have its own strategy which determines the type of investments and the methods of investment it undertakes. Hedge funds as a class invest in a broad range of investments extending over shares, debt, commodities and so forth.

A high minimum investment requirement, restrictions on withdrawals and the limited audience (wealthy, “sophisticated” investors) allow hedge funds to remain unregistered and leave managers free to pursue proprietary investment strategies that would be imprudent for a more widely held mutual fund. Hedge funds use aggressive trading strategies designed to earn positive returns in all market environments, such as short sales, leverage, program trading, arbitrage, and the use of derivatives. A hedge fund is structured as a limited liability partnership, and increasingly, the principals that manage the fund are also investors. This commitment of their own funds combined with a high water mark provision on fees reduces the principal-agent problems by aligning the interests of managers and investors. Lastly, the typical hedge fund has low transparency, with limited disclosure beyond its trading strategy to its investors and prime brokers.[21]

6. Hedge funds market

Hedge funds serve important market functions. By introducing specialization in trading strategies and financial analysis, hedge funds help ensure that markets are

[19] M.Kinga, P.Maier , page 1-2.
[20] P. Gaughan, p.60

comprised of many investors with heterogeneous views of value. When market participants disagree on value, they deploy capital in the direction they favor and, importantly, provide liquidity to markets through trading. They bet long (if they expect prices to rise) or short (if they predict a decline), and in so doing facilitate more efficient and accurate market pricing.

Sensible and dependable pricing has extraordinary value well beyond the capital markets, and hedge funds are given far too little credit for this ancillary benefit that emanates from their trading practices. Without effective price feedback loops, all parts of the modern economy, micro and macro, are at risk of misallocating their resources. One would think that busted bubbles (whether of the Internet or credit variety) would teach us the importance of efficient market pricing and caution against limiting players that facilitate price discovery.

In addition, the sheer abundance and diversity of hedge funds provide a counterbalance to the concentrated power of massive global banking institutions. Securities and Exchange Commission (SEC) Chairman William O. Douglas, a key figure in 1930s financial legislation, articulated an overarching goal of fragmenting economic power under the view that "tremendous power" lays in the hands of firms and people who have the ability to dominate financial markets. Hedge funds are market-based fragmenting of capital (both cash and human) with the salutary effect of dispersing power of banks. [22]

7. Largest Hedge Funds by assets

Nonetheless, while industry statistics are somewhat murky, the successful growth of hedge funds is without debate. This industry has been reported to be as large as $1 trillion, with as many as 8,000 hedge fund managers active in the United States. Moreover, hedge funds may account for as much as half of all the trading on the New York Stock Exchange. [23]

[21] M.Kinga, P.Maier , page 1- 2
[22] J.Ballabon.

[23] P.Gaughan, p. 59

Single manager funds as of March 5, 2008:[24]

Name	AUM
JP Morgan	$44.7bn
Farallon Capital	$36bn
Bridgewater Associates	$36bn
Renaissance Technologies	$34bn
Och-Ziff Capital Management	$33.2bn
Goldman Sachs Asset Management	$32.5bn
DE Shaw	$32.2bn
Paulson and Company	$29bn
Barclays Global Investors	$18.9bn
Man Investments	$18.8bn

Top 10 U.S. Hedge-Fund Firms[25]	**Firm AUM ($ billions)**
Bridgewater Associates	$38.6
JPMorgan	$32.9
Paulson & Co.	$29
D.E. Shaw Group	$28.6
Och-Ziff Capital Management	$22.1
Soros Fund Management	$21
Goldman Sachs Asset Management	$20.6*
Farallon Capital Management	$20
Renaissance Technologies	$20
Barclays Global Investors	$17*

*As of Dec. 31. All other figures as of Jan. 1

[24] "Hedge Fund", 18 January 2009, available at <http://en.wikipedia.org/wiki/hedge>
[25] http://www.bloomberg.com, January 2009

8. Failure of hedge funds

A key difference between hedge funds and other financial actors is that the rate of hedge fund failure is considerably higher. There is a shortage of accurate data on the failure rate of hedge funds. One estimate suggests hedge fund attrition rates ranged between 3.8% and 5.1% per year between 1999 and 2007 (ISFL, 2008). Other studies use the number of funds that stop reporting to the Lipper TASS database. According to this proxy, the average life span of a hedge fund is 40 months, with a median life of 31 months. Fewer than 15% of hedge funds last longer than 6 years, while 60% disappear with 3 years. Table 2 reports average attrition rates for different investment strategies. Directional hedge funds have the highest attrition rates, followed by multi-strategy funds. According to Hedge Fund Research, 2005 was a record year for hedge fund liquidations, with nearly 850 hedge funds closing down. By comparison, 563 hedge funds closed in 2007, with another 350 hedge funds closing over the first 6 months of 2008. At this pace, the total closures for 2008 will represent around 7% of the industry. A number of the highest profile victims of the credit crisis have been hedge funds owned or managed by regulated LCFIs, such as two Bear Stearns hedge funds ($1.6 billion) and Dillon Read Capital Management ($3.5 billion). The proprietary trading desks at LCFIs have also reported large losses, with Morgan Stanley's loss of $7.8 billion providing one example among many. Lastly, Cole et al. (2007) point out that these frequent failures of hedge funds have not resulted in a financial crisis.

Table 2
Average annual attrition rates, 1994–2003.

Strategy	Category	Rate
Directional	Managed futures	14.40%
	Global macro	12.60%
	Emerging markets	9.20%
	Dedicated short bias	8.00%
	Long/short equity	7.60%
Market neutral	Fixed income arbitrage	10.60%
	Equity market neutral	8.00%
	Convertible arbitrage	5.20%
Event driven		5.40%
Multi-strategy		8.20%
Fund of funds		6.90%

Source: Chan et al. (2005). [26]

[26] M.Kinga, P.Maier , page 1-2.

B. PRIVATE EQUITIES

1. General Information

The private equity industry has seen tremendous growth over the last decade, going from less than $10 billion raised worldwide in 1991 to over $180 billion in 2000 (Kaplan and Schoar, 2005). Almost a decade later, private equity shows no signs of slowing down. In fact, the industry raised a record $406 billion in 2006.

Table 1 shows a summary of the leading private equity funds and buyout firms in terms of total value of funds raised over the last decade.

Table 1: Top private equity funds

All funds	
Firm	**Funds raised in the past 10 years**
Goldman Sachs	$66.4bn
Blackstone	$58.4bn
Carlyle	$52.5bn
Credit Suisse	$32.4bn
TPG	$32.0bn
KKR	$31.7bn
Warburg Pincus	$31.7bn
Apax	$30.9bn
Bain	$30.8bn
Permira	$29.0bn
Buyout funds	**Funds raised in the past 10 years**
Goldman Sachs	$36.5bn
Blackstone	$33.7bn
KKR	$31.7bn
TPG	$29.7bn
Carlyle	$29.2bn
Permira	$29.2bn
Bain	$26.1bn
CVC	$25.1bn
Silver Lake	$21.8bn
Providence	$20.2bn

Source: Private Equity Intelligence

2. Definition of Private Equities

An important source of confusion and controversy appears to be the lack of a generally accepted definition of private equity. This is not just a purely academic question, but an important – and perhaps crucial – obstacle to regulation, since private equity activities can conceivably be carried out in many different legal forms. For example, private equity activities may be carried out by companies instead of partnerships. Attempts to regulate one form of private equity might then be contravened by the appearance of new functional forms. Alternatively, regulation may have to be very comprehensive and costly for it to be effective.

Private equity/buyout firms are defined as investment funds which:

- buy, own and sell controlling positions (typically close to 100%) in mature companies;
- finance a substantial part (e.g. 2/3) of their investments by debt;
- employ fund managers paid by performance (e.g., 20% of financial returns in excess of 8% a year);
- have a finite life span and are dissolved after a finite number of years (e.g., 5).[27]

A company will be a private fund only if it permits investors to redeem their interests in the fund within two years of purchasing them.[28]

Private equity firms are a unique and pervasive creature of the capital markets. Structured as long-term, illiquid investment vehicles, these firms typically take controlling positions in private operating companies that have been, among other things, emancipated from a larger public company, transitioned from private ownership, or built by rolling up smaller enterprises into a single firm.[29]

3. Private equities Investors

Private equities are equity securities of companies that have not listed their stock on a public exchange. As they are not listed on an exchange, any investor who wishes to sell these securities in private companies must find a buyer in the absence of a public marketplace/exchange.[30]

[27] S.Thomsen, "Should Private Equity Be Regulated?", European Business Organization Law Review 10, Cambridge University Press (2009), p. 98-99.
[28] "SECURITIES AND EXCHANGE COMMISSION" (2004), p.38
[29] J. Ballabon
[30] J.Zabasky, available at <http://www.streetdirectory.com/travel_guide/37201/investment/just_what_is_a_private_equity_investment.html>

Private equity firms raise their capital from a variety of sources, including institutional investors such as pension funds. These investors have looked to private equity firms as a way of achieving higher returns on their portfolio of investments.

This became more important when interest rates fell and then the stock market also fell as we moved into the 2000s. These institutional investors may place a portion of their capital with various different private equity funds; thus, the portion of their capital devoted to the private equity may be diversified across a few funds. In addition, their overall portfolio is diversified with holdings in many other investment categories such as stock, bonds, and money market investments. The private equity component of their overall portfolio may provide higher returns but would have more risk and be less liquid than their debt and money market investments.

Wealthy individuals are also investors in private equity funds. They also invest some of their capital in private equity funds in pursuit of the higher returns they will hopefully pay. As funds have grown dramatically in size, the percentage of total private equity capital provided by individuals has become somewhat less important.[31]

4. Private equity capital

As mentioned before, private equity market is a collection of funds that have raised capital by soliciting investments from various large investors for the purpose of taking equity positions in companies.

When these investments acquire 100 percent of the outstanding equity of a public company, we have a going-private transaction. When the equity is acquired through the use of some of the investment capital of the private equity fund but mainly borrowed funds, we tend to call such a deal a leveraged buyout (LBO). The fact that these deals are very common investments for private equity funds has led some to call these funds LBO funds. However, private equity funds may make other investments, such as providing venture capital to nascent businesses. Funds established for this purpose are sometimes called venture capital funds. Private equity funds seek out investments that are undervalued. These could be whole companies that are not trading at values commensurate to what the fund managers think would be possible. They could also be divisions of companies that want to sell the units due to a change in strategy or a need for cash.

Funding for private equity firms often comes from larger pools of capital, such as pension funds and charitable endowments seeking alternative investments to help

[31]P. Gaughan, p. 59

generate outsized returns to fund their long-dated liabilities. Historically, the key to private equity firms' success was not only the longdated nature of their capital but cheap and easy financing in the form of leverage extended by investment banks and then syndicated to other financial institutions. Until recently, with as little as 10-20% down, private equity firms were able to purchase and control enormous enterprises.

With such power comes scrutiny. Lambasted as "locusts," "vultures," and other less flattering epithets—particularly by domestic and foreign free market critics—these firms are under increasing pressure. The high debt loads which fund their purchases are seen by some as a potentially destabilizing force in the capital markets and beyond as economic contraction looms large. It is likely, however, that negative impulses in reaction to private equity are both overstated and misguided, barring the menacingly self-fulfilling prophecy of populist regulatory intervention.

Given their relatively longer investment horizons, private equity funds could prove uniquely positioned to withstand the current credit storm—provided it is not overly prolonged. Private equity firms typically aim to "harvest" (i.e., sell) their investments 3-5 years after acquisition. In the hands of patient capital, private equity portfolio companies can weather the credit crisis with owners who recognize the difference between illiquidity (the short-term inability to freely finance, buy, or sell at full value) and insolvency (a fundamental inability to fund operations on an on-going basis).

As rational actors, private equity firms can be expected to shield fundamentally sound but illiquid businesses and assets until market conditions improve. Similarly, they should be expected to restructure and/or shed businesses and assets that prove to be uneconomical. Moreover, there is no doubt that they will find value in the remains of failed businesses.[32]

5. Private equities strategies

Thus, Investors in private securities require other avenues to gain a return on their investments. This return may come in a variety of ways: an initial public offering, a sale or merger, or through participating preferred shares.

The last option, participating preferred shares, is the most reliable and consistent. If offers investors the opportunity to directly participate in the profits of the company in which they invested. These profits are generally paid out in qualified dividends on a quarterly basis. The fact that they are qualified dividends makes private equity through participating preferred shares even more attractive because the tax rate for most individuals is only 15% on the income received.

6. Private equities' popularity

[32] J. Ballabon

One of the many reasons why this type of investment is so popular to businesses is because it provides long - term, committed share capital which can help private companies grow and succeed. As the investment is made in exchange for a stake in the company, the investors' returns are dependent on the growth and profitability of the business. As a result, investors are generally only interested in companies with high growth prospects. However, provided there is real growth potential the private equity industry is interested in all stages, from start - up to buy - out. The benefits of this type of investment definitely outweigh the risk, as private equity backed companies have been shown to grow faster than other types of businesses. This is made possible by the provision of a combination of capital and experienced personal input from private equity executives, which sets it apart from other forms of finance. Private equity can help you achieve your ambitions for your company and provide a stable base for strategic decision making.[33]

7. Private Equities' Risk

And even a wave of private equity led defaults is unlikely to stir up serious systemic risk. A study by the McKinsey Global Institute concludes that private equity borrowing continues to form only a small part of the overall corporate debt market, 11% of overall corporate borrowing in the U.S. and Europe in 2006. According to Diana Farrel, Director of McKinsey Global Institute, if we assume a spike of private equity defaults of 15% from the historic highs of 10%, estimated implied losses would equal only 7% of the 2006 syndicated lending issuance in the U.S. and 3% in Europe. As McKinsey's study points out, private equity-owned companies are worth just 5% of the value of companies listed on U.S. stock markets and 3% of those in Europe.

Unfortunately for private equity funds the political climate is ominous. The Treasury Department's recently released blueprint for future market regulation envisions much greater scrutiny. Under Treasury's long-term "optimal" plan, the Federal Reserve would act as a safety and soundness regulator with the power to extract "detailed financial information" from any firm viewed as engaging in investments with potentially system-wide effects. The proposal even envisions a central bank that can more or less impose any "corrective actions to address financial stability problems."

More than anything else, private equity firms are allocators of capital. They can be trusted to serve their own profit motives, and as such maximize the value of their holdings. There is reason to doubt that regulators operating under pressure-driven

[33] J. Zabasky

political mandates (even with the advantage of economy-wide information) would do so much better as to justify their intrusion into lawful investment activities.[34]

C. COMPARISON BETWEEN HEDGE FUNDS & PRIVATE EQUITIES FUNDS

Hedge funds are similar to private equity funds in many respects. Both are lightly regulated, private pools of capital that invest in securities and compensate their managers with a share of the fund's profits. Most hedge funds invest in relatively liquid assets, and permit investors to enter or leave the fund, perhaps requiring some months notice. Private equity funds invest primarily in very illiquid assets such as early-stage companies and so investors are "locked in" for the entire term of the fund. Hedge funds often invest in private equity companies' acquisition funds.[35]

Although private equity funds and hedge funds are often lumped together, it is very important to distinguish between the two categories. Hedge funds may be activist investors that try to influence corporate governance, but they typically do not acquire controlling ownership stakes. In contrast, private equity funds nearly always acquire control.[36]

Hedge funds may purchase securities with a short-term investment horizon and often look to sell their investments at the most opportune time, even if this means a short holding period. Hedge fund investors may be able to cash out their investments after a certain initial “lock-up” period. Hedge funds that have more liquid assets will normally be able to accommodate such redemption requests. Funds that seek to invest in less liquid investments may require a longer lock-up period. Private equity funds, however, make longer-term, less liquid investments and are usually not in a position to accede to such requests. As a result, private equity investors must be willing to accept a long-term investment strategy. Their returns will be provided when the private equity fund cashes out its investments, such as when a company it has purchased is sold. However, we have already noted some exceptions to this, such as when private equity firms engage in dividend recapitalizations. Hedge funds traditionally have not been that active in the operations of the companies they invest in. On the other hand, private equity funds normally make large investments in

[34] J.Ballabon

[35] “Hedge Fund”, 18 January 2009, available at <http://en.wikipedia.org/wiki/hedge>

[36] S.Thomsen, p. 99

particular companies and play an active role in selecting management and overseeing their performance.[37]

Finally, private equity funds are often treated as a single entity in public discussion, but there are substantial differences among them. For instance, the investment focus may differ by portfolio firm size, industry focus, domestic or international focus, seller type (industrial, family), track record and experience. In addition, some private equity firms (3i, Capman or Blackstone and, soon perhaps, KKR) are publicly listed, while others are not.

It is tempting to inquire why the confusion of definitions persists despite numerous attempts at clarification. One reason may be that it is endogenously generated in public discussion because different interest groups have different vested interests in labelling. For example, proponents of private equity may want to include venture capital in an overall definition because venture capital has a better public reputation for contribution to innovation. In contrast, critics may want to include hedge funds in the definition of private equity because of their bad press as short-term speculators. The formal, legal differences between different funds may be relatively small, while the nature of their business is in fact very different. There may also be some overlap in their work; for example, many private equity funds became involved in the dot.com firms at the end of the 1990s (Cheffins and Armour 2007). Thus, it may be difficult to curtail private equity and hedge funds without unintentionally also reducing venture capital activities.[38]

The most fundamental difference: private equity funds seek to buy all of the equity of companies; hedge funds are not constrained to controlling equity investments. Highlighted below are other major differences between the two types of funds.

1) **Time to hold.** Whether investing in debt or equity, hedge funds typically demand a much more rapid exit strategy than private equity funds. Hedge funds generally seek a quick flip of their investments, often in as few as six months and most likely in no more than 18 months. However, some hedge fund investments are "loan to own;" that is, they buy debt at a deep discount with an eye toward converting that debt to equity, then monetizing that equity (through a recapitalization, refinancing, sale, merger or other disposition) in a short time period. This is a function of, among other things, the liquidity and leverage differences between the two types of funds. Investments by private equity firms often are held for five to seven years, sometimes longer. The time-hold differences directly affect the exit strategy, risk tolerance and desired rate

[37] P. Gaughan, p. 61-62

[38] S.Thomsen,p.99

of return of the two types of funds. What does all this mean to secured lenders? Simply this: if hedge funds buy debt held by a bank group, we must be prepared for a transaction that results in distributions of both debt and equity to the secured lenders.

2) **Liquidity and leverage.** The different hold periods are driven in large part by the different use of leverage and liquidity demands for the types of funds. Put simply, hedge fund investors generally are able to withdraw their investments more frequently than private equity fund investors. For hedge funds, volatile withdrawal demands force a focus on short-term returns and may lead to shorter hold periods.

3) **Strategic direction.** Having longer hold periods, private equity funds are very interested in the strategic direction of the companies and industries in which they invest. For that reason, prior to making an investment, private equity firms engage in a significant amount of research regarding both the targeted company and the industry in which it operates. Once an investment is made, private equity firms devote substantial "hands-on" time to further develop strategies, assess and evaluate results, and make changes on accordingly. This generally translates into active participation on a board of directors. Hedge funds assess target companies' strategies with a different focus, one tied to hold periods, returns and company and industry hedging strategies. However, hedge funds are increasingly seeking board seats and looking to influence management decisions made by companies in which they have invested.

4) **Due diligence methodology.** The degree of due diligence performed is another distinction. Although both investors have well-developed methodologies for performing due diligence, typically hedge funds rapidly execute due diligence because their exit strategy may be vastly different. Due diligence performed by private equity funds typically takes longer and may be more detailed. A high-level of financial sophistication exists with both types of funds; consequently, each takes a customized approach to due diligence.

5) **Risk tolerance.** Whether prospectively investing in a healthy or distressed company, the risk tolerance level of the private equity fund is measured carefully to include both short- and long-term risk evaluations. The private equity firm is able to adjust its tolerance for risk as market conditions change. With the longer period of time to maturity of the investment, a more risk-averse investment style and resources dedicated to the operations of the company, private equity firms have a lower tolerance for risk than hedge funds.

6) **Mark to market.** The hedge fund frequently marks its investment to market and utilizes this valuation methodology in its decision-making regarding exit strategies.

Private equity funds tend to use long-term valuation methodologies when valuing their investments.

7) **Desired return on investments.** Hedge funds strive for higher levels of return than private equity funds. However, there may be significant differences in how private equity and hedge funds define "return." Hedge funds typically rely upon a fairly straightforward methodology pursuant to which return is based on the difference between invested value and sales proceeds. The private equity firm's desired return on an investment may be adjusted based on several factors, including market share, profitability, revenues and valuation metrics.

8) **Control.** When they buy the equity of a target company, private equity firms may replace the company's senior management. However, finding top-notch management is, in many instances, more difficult than finding the right investment. Even if senior management is retained, the private equity fund will control the board of directors. Thus, the equity sponsor has a direct impact on the strategic direction of the company. Newly appointed directors are often principals of the private equity firm. In the case of many hedge fund investments, management may often be left alone while the hedge fund works toward a buy-and-sell trading position in debt or equity. The trading position often is protected through esoteric and complicated hedging strategies. However, in a "loan to own" investment, the hedge fund may mimic the private equity fund with respect to both management and board involvement.

9) **Assessment of EBITDA, leverage, liquidity and other standard financial metrics.** Although hedge funds and private equity firms likely calculate EBITDA, leverage, liquidity and other standard financial metrics in the same manner, given their different risk appetites and hold periods, they have different views regarding where a particular company's financial metrics should be at a specific stage of a deal.

10) **Industry focus.** Volatility is valued by certain investors and avoided by others. Hedge funds view volatility as an advantage and an accelerant to higher rates of return, especially given their ability to hedge their investments through company or industry counter "bets." Astute management, a competitive industry and a volatile marketplace can fuel the fire of high returns and profits. Hedge funds typically focus on underperforming companies because such companies are more volatile, creating a corresponding potential for higher returns.

11) **Management fees.** Management fees, like engaging in mark-to-market valuation, can cause additional profit-taking pressures. In the case of the private equity investment, the management fee usually is end-loaded and, as a result, emphasizes the long-term result of holding the investment. However, given the recent relative

abundance of capital in the market, private equity funds have been agressively refinancing their investments, using new leverage to pay dividends to their investors.[39] Hedge funds, on the other hand, charge fees based upon a hypothetical asset price, so when such prices increase, they receive a fee, but when they decline, they do not give investors a refund.[40]

The hedge fund calculates its management fee in a much shorter time frame and, combined with the mark-to-market pricing pressure, this furthers the aggressive nature of the hedge fund investment methodology.

D. CONCLUSION

Secured lenders invest in a company's debt, with a view toward a definite yield over a specific time period. Private equity firms generally invest in a company's equity, with a long-term view seeking large "equity-upside" returns. Hedge funds may invest in secured debt, unsecured debt or equity, and may hedge those investments through intracompany hedges or industry hedges, while seeking extraordinary returns. The hedge fund exit strategy may be a simple trade, as opposed to a complete corporate disposition. However, when "loan to own" hedge funds invest in debt securities of portfolio companies owned by private equity funds, the different funds' risk tolerance, hold periods, and leverage and liquidity issues inevitably will result in a culture clash. Depending upon the secured lenders' appetite for debt versus equity, the culture clash may result in the lender abandoning the equity sponsor and siding with the short-term equity flip strategy employed by a loan-to-own hedge fund. There have been recent deals where equity sponsors seeking new financing have imposed restrictions on a lender's ability to transfer debt to certain types of institutions. Knowing the major differences between the types of funds will enable a secured lender to anticipate behavior in transactions involving both types of funds and will enable a borrower to better understand the motivations of its lenders and investors.[41]

[39] M. Thomas and P. Young, "What Commercial Borrowers and Lenders Should Know About Private Equity vs. Hedge Funds", April 2006, available at <http://corp.bankofamerica.com/public/public.portal?_pd_page_label=products/abf/capeyes/archive_index&dcCapEyes=indCE&id=317>

[40] Patrick A. Gaughan, "How Private Equity and Hedge Funds Are Driving M&A", 2007 Wiley Periodicals, Inc, p.59

[41] M. Thomas and P. Young

ΠΑΝΕΠΙΣΤΗΜΙΟ ΠΕΙΡΑΙΑ

PART II – HEDGE FUNDS REGULATION

INTRODUCTION

Hedge funds are the runts of the capital markets. Neither a dominant force on a relative or absolute basis, these small, nimble players can nonetheless achieve extraordinary results. As hedge funds grow larger and more bank-like, however, there is no doubt that calls for their regulation will increase; but hedge funds already are subject to significant regulation and forced transparency.[42]

A. HEDGE FUNDS PROBLEMS

The most obvious risk factor for hedge funds is the possibility of direct investment in the securities of troubled or bankrupt companies, particularly in the financial sector. Hedge funds may have had direct investment in stocks or bonds or "synthetic" positions through derivatives, for example in long/short funds. Indeed many hedge funds have been short financial stocks and will therefore have gained from falls in their value.[43]

Hedge fund failures while uncommon have devastating financial consequences. In some cases the failure can be a series of ill-timed trades and in other cases fraud may cause it to fail. The major problem with fraud is that some hedge funds do not use a third party to hold their assets which gives them the ability to misrepresent fund growth and performance to increase compensation. Several high profile cases of fraud have been publicized in recent months. The Senate Judiciary Committee has recently begun hearings concerning the propriety of hedge funds. However critics say that the SEC currently lacks the workforce and expertise to monitor the estimated 7,000 hedge funds in operation.[44]

Thus, hedge funds hardly are the popularly depicted ravenous vampires of the capital markets, casting neither shadow nor reflection. If regulators truly do view a collective failure of these firms as an emerging source of systemic risk or action, they should acknowledge the benefits they provide and enhance transparency by providing more carrots than sticks as they contemplate regulation.

Finally, transparency to regulators does not necessarily mean greater transparency to other market participants. Private investment partnerships may object less to providing insight to regulators, so long as they do not have to share their ideas (and potential profits) with their competition in the capital markets.[45]

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[42] J. Ballabon
[43] S.Fox & R.Howie, "Where next for hedge funds" 10 October 2008, available at <www.me,rcer.com.>
[44] "Hedge Funds" available at <www.hedgefundquestions.org.>
[45] J. Ballabon

B.METHODS OF HEDGE FUNS REGULATION

Given their growing size, the potential damage from a hedge fund collapse may have increased due to the tighter linkages in the global financial system. A case can be made that more direct regulation of hedge funds is warranted. Below, the arguments for direct regulation and the alternative based on indirect regulation and market discipline are examined:

a) I) Direct regulation of hedge funds

The case for direct regulation is based on a view of market failure, where the risk management practices of creditors and counterparties are inadequate, and their actions many not prevent hedge funds from taking excessive risk. A lack of transparency, the use of multiple prime brokers, and the incentives of competing brokers to offer attractive terms to hedge funds might prevent indirect regulation and market discipline from being effective. Implicit in this argument is the view that a hedge fund failure or the inadvertent decisions of hedge funds may have systemic consequences. In this case, a central planner can mitigate this market failure by regulating greater transparency.

II) Proposed form of direct regulation

Proponents of direct regulation make a number of proposals. A first approach is to require mandatory registration of hedge fund managers, or the distributors of their products. In this view, hedge funds should be held to the same standard as mutual funds, as their investments are increasingly becoming available to lower net worth individuals. Registration of hedge fund advisers is compulsory in much of Europe and Canada, and efforts are underway in the US and Japan in this area. While this type of regulation would address concerns related to investor protection, it does not address systemic issues.

A second approach is to require more disclosure, either to prime brokers or to supervisors. Increased position transparency, it is argued, would allow prime brokers to monitor and limit excessive hedge fund leverage, and mitigate the potential systemic risk through effective counterparty risk management.

But position transparency raises the concern that prime brokers or their proprietary trading desks may use this information to their advantage, as occurred in the case of Amaranth. The alternative approach is to provide more transparency on hedge fund positions or credit exposures to supervisors through the creation of a centralized global registry for all hedge funds. Such a registry could be used to identify concentrations of counterparty credit risk or concentrations in trading strategies (i.e. crowded trades) that

might lead to herding and contagion. Danielsson et al. (2005) argue that this approach is infeasible, because by the time supervisors have received and analyzed this large amount of complex information, the information might have no value. In terms of crowded trades, it is not clear how supervisors would communicate such concentrations, even if they could be identified in a timely fashion. And hedge funds that did not wish to comply could re-locate their trading operations to a lower regulated, off-shore domicile.

b) I) Indirect Regulation of hedge funds

The alternative to regulating hedge funds directly is a combination of indirect regulation and effective market discipline. Indirect regulation by prime brokers implies that supervisors focus their attention on collateral and risk management practices of their principal counterparties, namely their prime brokers. This approach has the advantage of being focused on the core institutions and channels through which systemic risk would be likely to propagate. It is also practical from a regulatory perspective, since it focuses on financial institutions that are already under the supervision of banking regulators.

Effective market discipline requires that creditors, counterparties, and investors obtain sufficient information to assess client's risk profiles. With this information, these agents can potentially limit excessive leverage, increase disclosure, and mitigate the potential systemic risk through effective counterparty risk management. The limited impact on financial markets of the liquidation of numerous hedge funds over the past 8 years is offered in support of this view.

II) How effective is indirect regulation?

If indirect regulation and market discipline are effective in reducing the potential systemic risk from the hedge fund sector, these approaches should result in reduced leverage, improved funding liquidity, increased disclosure, and improved counterparty risk management practices. Each of these issues is discussed in turn.

Has hedge fund leverage decreased? Anecdotal reports and survey evidence suggests that the degree of leverage at hedge funds has declined. A 2004 Bank of England survey suggests that approximately 20% of hedge funds used no leverage at the end of 2004, and that a further 50% used leverage of less than one times their equity (Bank of England, 2005). Similar surveys from Merrill Lynch report a decline in leverage over the course of 2007 and 2008.

Has hedge fund disclosure and transparency increased? Although hedge fund disclosure and transparency are difficult to measure, there are signs of improvement. Standard and

Poor's and Moody's, for example, have announced plans to publish operational risk ratings for hedge funds. As more institutional investors invest in this asset class, market pressure for more transparency has increased.

How effective is hedge fund counterparty risk management? The evidence is anecdotal but supportive. Amaranth's $6.6 billion collapse did not threaten its counterparties, or the broader financial system, as Amaranth's accounts were fully margined. Its losses on unregulated exchanges did not affect regulated exchanges (GAO, 2008). The evidence from the bankruptcy of Lehman Brothers suggests that collateral and haircuts were also effective in limiting losses at trading counterparties.

Has funding liquidity improved? Hedge funds are reducing exposure to funding illiquidity by seeking more stable sources of funding, such as longer investor lock-in periods, longer redemption notice periods, and debt issues. Some hedge funds are also negotiating credit lines for liquidity purposes. Others have responded to shortages of funding liquidity by raising permanent capital through equity offerings or by restricting redemptions. Between November 2007 and March 2008, 25 hedge funds froze redemptions to preserve liquidity. The increased participation of institutional investors in the hedge fund sector may also be expected to improve liquidity, as these investors have longer time horizons and a better understanding of hedge fund operations.[46]

C.REGULATORY AUTHORITIES

A defining characteristic of the hedge fund model is their low level of regulation and supervision. In theory, hedge funds may be subject to securities regulations at three levels of their business—the fund itself, the fund manager, and the distribution of the fund. In practice hedge funds are often structured so as to be exempt. The primary or lead regulator is determined based on the hedge fund's legal domicile. In 2006, 55% of hedge funds were incorporated offshore, taking advantage of minimum regulation and favorable tax treatment in places such as the Caribbean. Fund managers, however, are typically based on major financial centers such as London or New York, where they are not required to be registered with local supervisory authorities. Distributors of hedge fund products must be registered in Canada and Europe, but may avoid registration in the United States if they qualify for certain exemptions.[47]

In the wake of the significant liquidity and credit contraction affecting global capital markets, the Emergency Economic Stabilization Act of 2008 (the "Act") and recent measures taken by domestic and foreign regulatory authorities, including the Securities and Exchange Commission (the "SEC") and the Financial Services Authority (the

[46] M. Kinga, P. Maier , page 1-2.

"FSA"), have served to target the reduction of market volatility, the increase of financial transparency, and the restoration of confidence in the financial markets. Current market conditions, as well as the new legislation and recently adopted regulations have, and will continue to have, serious implications for investment managers and for the hedge funds and private equity funds they manage, as well as direct effects on their trading strategies, compensation arrangements, disclosure requirements, and compliance obligations.[48]

In practice, many of the largest hedge funds are subject to substantial oversight through their trading activities. US-based hedge funds themselves are not regulated. Instead US regulators target hedge fund advisors who must be registered as investment advisers if certain conditions are not met. The SEC regulates an estimated 1991 hedge fund advisers, including 49 of the largest US hedge fund advisers representing one-third of the hedge funds' assets under management in the US (GAO, 2008). These advisers are subject to SEC examinations and reporting, record keeping, and disclosure requirements.

Despite an acknowledged lack of expertise, the SEC is active in monitoring these advisers. In 2006, it inspected 321 hedge fund advisers and issued 294 deficiency letters for inadequate disclosure, failure to report personal trading, and inadequate risk procedures. Of these cases, 23 resulted in enforcement referrals related to fraud. Overall, the SEC brought a total of 113 cases against hedge funds from October 2001 to June 2007 for misappropriation of funds, insider trading, falsified credentials, and misrepresentation of past returns.

Hedge funds trading on US regulated futures and options markets are supervised by the Commodities Futures Trading Commission (CFTC), acting through the National Futures Association. In 2008, the CFTC reports that 29 advisers of the largest 78 US hedge funds were registered as Commodity Pool Operators or Commodity Trading Advisors. These traders are required to report their futures and options positions above a designated threshold, and are required to post margin with futures commission merchants (who themselves must maintain minimum capital requirements). Thus, a significant proportion of hedge funds are registered with the CFTC. The same is true for jurisdictions such as the United Kingdom and Japan.

[47] M. Kinga, P. Maier , page 1-2.

[48] Morgan Lewis, "Financial Crisis Impact and Analysis",2008, available at <www.morganlewis.com>

ΠΑΝΕΠΙΣΤΗΜΙΟ ΠΕΙΡΑΙΑ

PART III – U.S REGULATION

A. HEDGE FUNDS REGISTRATION IN US

The typical public investment company in the United States is required to be registered with the U.S. Securities and Exchange Commission (SEC). Mutual funds are the most common type of registered investment companies. Aside from registration and reporting requirements, investment companies are subject to strict limitations on short-selling and the use of leverage. There are other limitations and restrictions placed on public investment company managers, including the prohibition on charging incentive or performance fees.[49]

B. REPORTING POSITIONS OF REGISTERED HEDGE FUNDS

As soon as hedge funds amass 5% stakes in listed companies, they are typically forced to disclose publicly their positions (as well as the prices they paid and the timing of each purchase) by way of filings with the SEC. Once they reach 10% ownership positions, every transaction must be publicly reported. Firms that manage in excess of $100 million are required to report publicly the bulk of their listed company holdings on a delayed quarterly basis. Holdings in derivative instruments such as customized options or exotic equity swaps are not publicly disclosed as a matter of requirement, but these financial instruments are traded on the so-called over-the-counter market (i.e., face to face with bank counterparties). As a result, a hedge fund's bank counterparties know what it holds, how much it holds, what it is worth, when it buys and when it sells and there is complete transparency for all such transactions from the bank's end. [50]

C. BENEFITS FROM HEDGE FUNDS REGULATION

Commentators have stated that the SEC currently has neither the staff nor expertise to comprehensively monitor the estimated 8,000 U.S. and international hedge funds. One of the Commissioners, Roel Campos, has said that the SEC is forming internal teams that will identify and evaluate irregular trading patterns or other phenomena that may threaten individual investors, the stability of the industry, or the financial world. "It's pretty clear that we will not be knocking on hedge fund doors very often," Campos told several hundred hedge fund managers, industry lawyers and others.[51]

The SEC recently announced that it will expand its investigations by undertaking additional enforcement measures designed to address market manipulation and that certain hedge fund managers and institutional investors with significant trading activity in financial issuers or positions in credit default swaps will be required to disclose such

[49] "Hedge Fund", 18 January 2009, available at <http://en.wikipedia.org/wiki/hedge>

[50] US Securities & Exchange Commission, "Hedging Your Bets A Heads Up on Hedge Funds and Funds of Hedge Funds", 03/26/2008, available at <www.sec.gov.answers.hedge.htm>

[51] "Hedge Fund", 18 January 2009, available at <http://en.wikipedia.org/wiki/hedge>

positions to the SEC. Along these lines, the SEC is investigating the dissemination of false and misleading information as a means of depressing asset prices in connection with certain trading strategies, and has ordered a number of private funds to disclose trading data in connection with such investigations. [52]

It is expected that hedge fund investors, advisory clients and advisers will benefit from the rule and rule amendments, although these benefits are difficult to quantify:

1. Benefits to hedge fund investors

(a) *Deter fraud and curtail losses.*

The SEC can take action against a hedge fund that defrauds investors, and there are a number of fraud cases involving hedge funds. Commonly in these cases, hedge fund advisers misrepresented their experience and the fund's track record. Other cases were classic "Ponzi schemes," where early investors were paid off to make the scheme look legitimate. In some of the cases, the hedge funds sent phony account statements to investors to camouflage the fact that their money had been stolen. That's why it is extremely important to thoroughly check out every aspect of any hedge fund it might consider as an investment.[53]

SEC's oversight may prevent or diminish losses that hedge fund investors would otherwise experience as a result of hedge fund advisers' fraud. Registration allows SEC to conduct examinations of hedge fund advisers, and examinations provide a strong deterrent to advisers' fraud, identify practices that may harm investors, and lead to earlier discovery of fraud that does occur. Registration also permits SEC to screen individuals seeking to advise hedge funds, and to deny entry to those with a history of disciplinary problems.

In the last five years, the Commission has brought or authorized 51 enforcement cases in which SEC assert hedge fund advisers have defrauded hedge fund investors or used the hedge fund to defraud others. Only eight of the 51 cases involve investment advisers registered with the Commission, with over $75.7 million in estimated aggregate investor losses. The remaining 43 cases involve advisers that were not registered with us, with over $1 billion in estimated aggregate investor losses. [54]

The SEC has recently adopted a number of new regulations applicable to the hedge funds industry, including antifraud rules, prohibitions against short selling of publicly

[52] Morgan Lewis
[53] US Securities & Exchange Commission, (2008)
[54] SECURITIES AND EXCHANGE COMMISSION (2004), p.44-47

traded common equity securities of an expansive list of financial services institutions and requirements to disclose applicable short positions on certain securities.[55]

(b) *Provide basic information about hedge fund advisers.*

Form ADV, is a simple form which asks for basic information on the investment advisor and will be filed in order to aid hedge fund investors in evaluating potential managers.[56] Filing Form ADV will require hedge fund advisers to disclose information about their business, affiliates and owners, and disciplinary history. As commenters pointed out, many investors currently lack good access to this information about their hedge fund managers. Although the information hedge fund advisers will be required to provide on their Form ADV filings and to comply with our rules cannot substitute for an investor's due diligence, it should aid investors by providing a publicly accessible foundation of basic information.

(c) *Improve compliance controls.*

Hedge fund investors should benefit from their advisers' improved compliance controls. Once registered, hedge fund advisers will be required to have comprehensive compliance procedures and to designate a chief compliance officer. Specific procedures governing proxy voting and a code of ethics including requirements for personal securities reporting will also be required. In addition, the obligation to commit to a program of compliance controls combined with SEC's examinations foster adherence to a culture of compliance by advisers. These compliance measures are the first line of defense in protecting investors against an adviser's misconduct.[57]

2. Benefits to mutual fund investors

Mutual fund investors will benefit from hedge fund adviser registration to the extent that Commission oversight deters hedge funds and their advisers from illegal conduct that exploits mutual funds. Many of the market timers (people who make buy or sell decisions of financial assets by attempting to predict future market price movements) and illegal late traders involved in recent mutual fund scandals have been hedge fund advisers. The 51 enforcement cases discussed earlier (C 1.(a)) do not include 18 other actions we have brought to date against persons charged with late trading of mutual fund shares on behalf of hedge fund groups, and against mutual fund advisers or principals for permitting hedge fund advisers to market time mutual funds contrary to the mutual funds' prospectus disclosure. Hedge fund advisers reaped huge profits for

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[55] Morgan Lewis

[56] "Withdrawing from Investment Advisor Registration – the Form ADV-W", 24/11/2008, available at <http://www.hedgefundlawblog.com/withdrawing-from-investment-advisor-registration-%E2%80%93-the-form-adv-w.html>

[57] SECURITIES AND EXCHANGE COMMISSION (2004), p.44-47

their funds over an extended period while costing our nation's retail mutual fund investors hundreds of millions of dollars.

3. Benefits to other investors and markets

The registration of hedge fund advisers will benefit not only hedge fund investors but also other investors and the securities markets, to the extent that the Commission's oversight eliminates opportunities for hedge fund advisers to engage in other types of unlawful conduct in the securities markets. Adviser registration, as discussed above, should lead to earlier discovery of fraudulent activities and thus enhance protections to all investors in the securities markets.[58]

Hedge fund investors do not receive all of the federal and state law protections that commonly apply to most registered investments. For example, an investor won't get the same level of disclosures from a hedge fund that will get from registered investments. Without the disclosures that the securities laws require for most registered investments, it can be quite difficult to verify representations you may receive from a hedge fund. Also, while the SEC may conduct examinations of any hedge fund manager that is registered as an investment adviser under the Investment Advisers Act, the SEC and other securities regulators generally have limited ability to check routinely on hedge fund activities.[59]

4. Benefits to regulatory policy

Registration of hedge fund advisers will benefit all investors and market participants by providing us and other policy makers with better data. SEC has limited information about hedge fund advisers and the hedge fund industry, and much of what SEC does have is indirect information extrapolated from other data. This hampers SEC's ability to develop regulatory policy for the protection of hedge fund investors and investors in general. Hedge fund adviser registration would provide the Congress, the Commission and other government agencies with important information about this rapidly growing segment of the U.S. financial system.

5. Benefits to hedge fund advisers

The regulatory landscape for Investment Advisors is changing, and there have been attempts to register hedge fund investment managers.[60] Mandatory registration will provide a level playing field for hedge fund advisers. Many hedge fund advisers have already registered, and have organized their compliance procedures under the Advisers Act. Unregistered hedge fund advisers, however, vary substantially in their

[58] SECURITIES AND EXCHANGE COMMISSION (2004), p.44-47
[59] US Securities & Exchange Commission, (2008)

[60] US Securities & Exchange Commission (2008)

compliance practices. While many of them have adopted sound compliance practices, many others, against whom they and the registered advisers compete, have not allocated resources to implement an effective compliance infrastructure. SEC received comments noting that mandatory registration would ensure that all hedge fund advisers compete on the same basis in this regard.

Registering hedge fund advisers may enhance investor confidence in a growing and maturing industry. As discussed above, the hedge fund industry has been growing at an extraordinary pace in the past decade. Registration under the Advisers Act will bring hedge fund advisers to the same compliance level as other SEC-registered advisers, thus providing hedge fund investors with additional protections with respect to conflicts of interest addressed by the funds' advisers.

In addition, without the new rule requiring registration, a hedge fund adviser can now choose to register under the Advisers Act but then withdraw its registration, for example, at the prospect of an examination. Thus, without a registration requirement, any "moral hazard" would already exist, but without necessarily providing hedge fund investors the benefit of our oversight of their advisers.[61]

D. EXCEMPTIONS FROM HEDGE FUNDS REGISTRATION IN US

Although hedge funds fall within the statutory definition of an investment company, the limited-access, private nature of hedge funds permits them to operate pursuant to exemptions from the registration requirements. The two major exemptions are set forth in Sections 3(c)1 and 3(c)7 of the Investment Company Act of 1940. Those exemptions are for funds with 100 or fewer investors (a "3(c) 1 Fund") and funds where the investors are "qualified purchasers" (a "3(c) 7 Fund"). A qualified purchaser is an individual with over US$5,000,000 in investment assets. A 3(c)1 Fund cannot have more than 100 investors, while a 3(c)7 Fund can have an unlimited number of investors. However, a 3(c)7 fund with more than 499 investors must register its securities with the SEC. Both types of funds can charge performance or incentive fees.

In order to comply with 3(c)(1) or 3(c)(7), hedge funds are sold via private placement under the Securities Act of 1933. Thus interests in a hedge fund cannot be offered or advertised to the general public, and are normally offered under Regulation D. Although it is possible to have non-accredited investors in a hedge fund, the exemptions under the Investment Company Act, combined with the restrictions contained in Regulation D, effectively require hedge funds to be offered solely to accredited investors. An accredited investor is an individual person with a minimum

net worth of US $1,000,000 or, alternatively, a minimum income of US$200,000 in each of the last two years and a reasonable expectation of reaching the same income level in the current year. For banks and corporate entities, the minimum net worth is $5,000,000 in invested assets.[62]

Proposed US regulation

Hedge funds are exempt from regulation in the United States. Several bills have been introduced in the 110th Congress (2007-08), however, relating to such funds. Among them are:

- S. 681, a bill to restrict the use of offshore tax havens and abusive tax shelters to inappropriately avoid Federal taxation;
- H.R. 3417, which would establish a Commission on the Tax Treatment of Hedge Funds and Private Equity to investigate imposing regulations;
- S. 1402, a bill to amend the Investment Advisors Act of 1940, with respect to the exemption to registration requirements for hedge funds; and
- S. 1624, a bill to amend the Internal Revenue Code of 1986 to provide that the exception from the treatment of publicly traded partnerships as corporations for partnerships with passive-type income shall not apply to partnerships directly or indirectly deriving income from providing investment adviser and related asset management services.
- S. 3268, a bill to amend the Commodity Exchange Act to prevent excessive price speculation with respect to energy commodities. The bill would give the federal regulator of futures markets the resources to detect, prevent, and punish price manipulation and excessive speculation.

None of the bills has received serious consideration yet.[63]

E. US PRIVATE EQUITY – GROWTH LED TO GREATER REGULATORY SCRUTINY

SEC and others generally have not found private equity funds or their advisers to have posed significant concerns for fund investors. In a 2004 rule release, SEC stated that it had pursued few enforcement actions against private equity firms registered as

[61] SECURITIES AND EXCHANGE COMMISSION (2004), p.44-47

[62] “Hedge Fund”, 18 January 2009, available at <http://en.wikipedia.org/wiki/hedge>

[63] “Hedge Fund”, 18 January 2009, available at <http://en.wikipedia.org/wiki/hedge>

investment advisers. In commenting on the 2004 SEC rule, officials from committees of the American Bar Association and Association of the Bar of the City of New York noted that enforcement actions involving fraud and private equity firms have not been significant.

In addition, a SEC official told that the Division of Investment Management had received more than 500 investor complaints in the past 5 years but none involved private equity fund investors. In reviewing SEC enforcement cases initiated since 2000, seven cases were identified that involved investments in private equity funds and fraud. Five of the cases involved officials associated with a pension plan who invested the plan's money in private equity funds in exchange for illegal fees paid to them by the private equity firms. In one of the other two cases, SEC alleged that a private equity firm official misappropriated money that was meant to be invested in the firm's private equity funds. In the other, SEC alleged that a private equity firm official engaged in insider trading based on information received about a potential acquisition.

Officials from a labor union have told that one of their areas of concern regarding private equity funds was the level of protection provided to fund investors, particularly pension plans. They said that general partners (or private equity firms) must be accountable to investors, particularly in terms of their fiduciary duties to investors and protections against conflicts of interest. An association representing private equity fund limited partners, such as pension plans, found that the vast majority of members responding to an informal survey had not encountered fraud or other abuse by a general partner and viewed the funds as treating them fairly. Although the vast majority of survey respondents viewed themselves as sophisticated and able to protect their interests, they identified areas where funds needed to improve, such as fees, valuation of fund assets, and timeliness in reporting fund performance.

In a recent report, United States Government Accountability Office (GAO) found that pension plans which had been investing in private equity for more than 20 years, indicated that these investments had met their expectations and, as of late 2007 and early 2008, planned to maintain or increase their private equity allocation. Nevertheless, we also found that pension plans investing in private equity face challenges beyond those associated with traditional investments, such as stocks and bonds. The challenges included the variation of performance among private equity funds, which is greater than for other asset classes, and the difficulty of gaining access to funds perceived to be top performers, as well as valuation of the investment, which is difficult to assess before the sale of fund holdings.

SEC generally has not found private equity funds to have posed significant concerns for fund investors. However, in light of the recent growth in LBOs, U.S. and foreign

regulators have undertaken studies to assess risks arising from such transactions and have identified some concerns about potential market abuse and investor protection, which they are studying further.[64]

F. US REGULATION FOR PRIVATE EQUITIES

Private equity funds typically are organized as limited partnerships and structured and operated in a manner that enables the funds and their advisers (private equity firms) to qualify for exemptions from some of the federal statutory restrictions and most SEC regulations that apply to registered investment pools. For example, SEC staff has told that private equity funds and their advisers typically claim an exemption from registration as an investment company or investment adviser, respectively. Although certain private equity fund advisers may be exempt from registration, they remain subject to antifraud (including insider trading) provisions of the federal securities laws. In addition, private equity funds typically claim an exemption from registration of the offer and sale of their partnership interests to investors.

1. Advisers' registration

Nonetheless, several advisers to some of the largest private equity funds are registered, and SEC routinely has examined these advisers and found some compliance control deficiencies. At the same time, SEC and others historically have not found private equity funds or their advisers to raise significant concerns for fund investors—in part evidenced by the limited number of enforcement actions SEC has brought against such funds or their advisers. Nonetheless, in light of the growth in LBOs by private equity funds, U.S. and foreign regulators have undertaken studies to assess risks posed by such transactions and have identified some potential market abuse and investor protection concerns that they are studying further.

For example, about half of the 21 largest U.S. private equity firms have registered as advisers or are affiliated with registered advisers. From 2000 through 2007, SEC staff examined all but one of the private equity firms' advisers at least once. In the examinations we reviewed, SEC found some compliance control deficiencies, such as weak controls to prevent the potential misuse of inside information or to enforce restrictions on personal trades by employees.

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[64] United States Government Accountability Office, "Private Equity, Recent Growth in Leveraged Buyouts Exposed Risks That Warrant Continued Attention", September 2008, available at

2. Exemptions from restrictions

As private equity funds and their advisers (private equity firms) typically claim an exemption from registration as an investment company or investment adviser, respectively, SEC exercises limited oversight of these entities. Private equity funds generally are structured and operated in a manner that enables the funds and their advisers to qualify for exemptions from some of the federal statutory restrictions and most SEC regulations that apply to registered investment pools, such as mutual funds. However, in examining some registered advisers to private equity funds, SEC has found some control weaknesses but generally has not found such funds to pose significant concerns for fund investors.

3. Antifraud actions

Despite deficiencies, SEC and others have said that they generally have not found private equity funds to have posed significant concerns for fund investors. Since 2000, SEC has brought seven enforcement actions against private equity firms for fraud- five of which involved a pension plan investing money in private equity funds in exchange for illegal fees. An SEC official said that the Division of Investment Management has received more than 500 investor complaints in the last 5 years, but none involved private equity fund investors. Similarly, officials representing two institutional investor associations and two bar associations said that fraud has not been significant issue with private equity firms. However, in light of the recent growth in private equity funds, U.S. and foreign regulators, including SEC, have undertaken studies to assess risks arising from such transactions and have identified some concerns about potential market abuse and investor protection, which they are studying further.

4. Private Equity advisers

Private equity fund advisers that are registered with SEC are subject to the same regulatory requirements as other registered investment advisers. These advisers are required to maintain books and records and are subject to periodic examinations by SEC staff. They also must provide current information to both SEC and their investors about their business practices, disciplinary history, services, and fees but are not required to report specifically whether they advise a private equity fund exempt from registration under the Investment Company Act. As a result, SEC staff does not know which and, in turn, how many, of the registered advisers advise exempt private equity funds. The SEC staff said that they can determine whether a registered adviser advises a private equity fund when examiners go on-site to do an examination and through other information sources, such as an adviser's Internet site.

<http://www.gao.gov/new.items/d08885.pdf>

G. POSITIVE FINANCIAL IMPACT OF PRIVATE EQUITIES- RESEARCH OF GAO

Academic research that Government Accountability Office (GAO) reviewed generally suggests that recent private equity LBOs have had a positive impact on the financial performance of the acquired companies, but determining whether the impact resulted from the actions taken by the private equity firms versus other factors is difficult. The research also indicates that private equity LBOs are associated with lower employment growth than comparable companies.

SEC's ability to directly oversee private equity funds or their advisers is limited to those that are required to register or voluntarily register with SEC. For example, funds or advisers exempt from registration are not subject to regular SEC examinations or certain restrictions on the use of leverage and on compensation based on fund performance and do not have to maintain their business records in accordance with SEC rules. [65]

[65] United States Government Accountability Office, "Private Equity, Recent Growth in Leveraged Buyouts Exposed Risks That Warrant Continued Attention", September 2008, available at <http://www.gao.gov/new.items/d08885.pdf>

ΠΑΝΕΠΙΣΤΗΜΙΟ ΠΕΙΡΑΙΑ

PART IV – U.K REGULATION

A. HEDGE FUNDS

Regulatory action has not been limited to the United States. The FSA recently implemented new provisions with respect to its Code of Market Conduct, including prohibiting new short positions or additions to existing short positions with respect to the securities of certain U.K. financial sector companies as well as daily disclosure requirements for investors with short positions in excess of 0.25% of the outstanding share capital of a U.K. financial sector company.[66]

--The role of Financial Services Authority (FSA)

Below, it is explored, in little more depth how the FSA's regulation contributes to an environment that supports financial entrepreneurs. Firstly, FSA do not approach all the firms regulated in the same way. A small firm which is well run and which, because of its size or the nature of its business, poses little risk to consumers or financial stability will receive less attention from FSA than a firm which does pose significant risks; either because of the type of business it does or its size.

Where FSA identifies risk, will always look for a solution that harnesses or enhances market forces. And where regulation is necessary, FSA focuses on achieving the right outcomes rather than the prescription of detailed rules. Focusing more on outcomes and principles gives companies the freedom to deliver FSA's regulatory aims in a way that is most efficient for them and their customers. When it comes to controlling risks, firms may well develop approaches that differ in detail but are equally effective in terms of their outcome. In that case, they should be allowed to use these approaches rather than one arbitrarily laid down by the regulator.

Sometimes detailed rules are necessary where it is considered that a principle alone does not give sufficient clarity as to the standards FSA expects, or where a European directive has to be implemented. But FSA wants to shift the balance of our regulation further in the direction of principles. This holds true, even given the market events we are all currently witnessing.

In important areas of financial services FSA regulates activities which are unregulated in most other countries: hedge fund managers, for example. In other areas, FSA has deliberately chosen a level of regulation which is more demanding than that adopted in

[66] Morgan Lewis

some other countries. Indeed, FSA sees good quality regulation as a selling point for the UK. [67]

--Regulation's focus

The United Kingdom enjoys a complex and in some respects unique relationship with hedge funds. Hedge funds are located for tax reasons offshore, principally but not exclusively in Cayman Islands. But the UK is a major global centre for the managers of hedge funds: there are some 450 hedge fund managers in the UK, managing 80% of Europe's $450bn (c. €290bn) of hedge fund assets. So UK's regulation focuses on those entities over whom we have jurisdiction: the hedge fund managers themselves and the banks who finance and support their trading strategies and operations.

--Hedge Funds Managers

Hedge fund managers are treated as a particular type of asset manager. Like all UK fund managers, hedge fund managers located in the UK are subject to prudential and conduct of business regulatory requirements, which implement the relevant European directives. FSA ensures that hedge fund managers adopt systems and controls appropriate to the scale and nature of their business in order to deter and enforce against poor market behavior. The regulatory approach to hedge fund managers does not extend, however, to prescribing or second-guessing their investment strategies, or preventing those who invest in them from losing money. The vast majority of investors in hedge funds are institutional investors or sophisticated investors with access to portfolio investment advice. Investors of this nature are expected to exercise a substantial degree of responsibility for their investment decisions and to bear the risks of high rewards and significant losses that can occur.

--FSA's supervisory team

FSA's regulatory approach is risk-based, focusing resources where greatest risks are considered to statutory objectives of market confidence, consumer protection and fighting financial crime. FSA closely oversee a group of 35 of the larger managers from within a specialist supervisory team. This team visits and performs risk-assessments on these firms. Smaller hedge fund managers in the UK are supervised like any other small wholesale market firm, through a series of reactive and proactive projects and firm visits, and through reviews of their regulatory returns and other data.

[67] H.Sants (Chief Executive, FSA), "What is the role of regulation in facilitating the development of innovation & entrepreneurs", 15.10.2008, available at <www.fsa.gov.uk.pages.Library.Communication.Speeches.2008.1015.hs.shtml>

--Hedge funds and Banking Sector

In respect of financial stability, FSA's regulatory efforts are focused less on the question of whether particular hedge funds may or may not be losing money and more on the interaction of hedge funds with the banking sector which finances their activities and which itself is central to the sound, safe and efficient operation of the financial system. FSA believes that 'the main risk resides in hedge fund failures that may bring down a bank and thereby also endanger the stability of other banks and the payment system'.

Financial stability efforts are focused on the interaction between large banks and their hedge funds counterparties. In addition to regular supervisory work, a six monthly survey of prime brokers' hedge fund exposures is conducted which looks at the counterparty credit exposures of the 15 banking institutions which have the largest exposure to hedge funds. This helps to gauge the risk appetite of both hedge funds and prime brokers and to assess the ability of the banks to manage their counterparty exposures.

FSA's approach to hedge fund manager supervision, developed from the experience over the last 10 years, has benefited from engagement both with the industry and co-ordination with other international regulators. The regulatory tools continue to be applied diligently and the highest standards of risk management and market behavior are expected from both hedge fund managers and their regulated counterparties.[68]

B. PRIVATE EQUITY REGULATION

In 2009 the private equity industry has been delivering a clear message to governments around the world: far from being a cause of the current crisis, it is an important part of the solution. In the UK at least, that message has not fallen on deaf ears. Private equity is already regulated heavily in the UK, and recent moves towards self-regulation reflect recognition that greater transparency and disclosure are both desirable and inevitable. The industry has volunteered to work with regulators to come up with new rules that meet their concerns, and there is still some hope that this will deliver a workable solution.[69]

[68] Dan Waters (Director of Retail Policy and Themes and Sector Leader, Asset Management,FSA), ECON: Economic and Monetary Affairs Committee Public Hearing on Hedge Funds and Private Equity 8 April 2008, available at <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/0409_dw.shtml>

[69] S.Witney, Partner, SJ Berwin LLP "Private equity can be our saviour – if it's not demonized" , 16 March 2009, available at <www.thelawyer.com>

--The Walker Report

The UK Walker Report (2007) is a voluntary initiative by the British Venture Capital Association (BVCA) focusing on disclosure and transparency in UK private equity. Tax policy is not discussed, but the report concludes that there is a major transparency and accountability gap to be filled. The report therefore proposes voluntary guidelines on a comply-or-explain basis. The recommendations are directed at both portfolio companies, fund managers and the BVCA. The guidelines apply to funds approved by the British Financial Standards Authority and concern only large portfolio firms with a value of more than £300 million (£500 million for private acquisitions), more than 50% of revenue generated in the UK and more than 1,000 employees in the UK. It is interesting that only companies with more than half their revenue generated in the UK are to be included, since this would imply that other countries would have to propose codes of their own to ensure similar information access.

--Private Equities' Regulation Defenders

Regulation advocates will probably not hesitate to see this as a demonstration of the need for pan- European regulation. Walker et al. recommend that such portfolio companies should publish an annual report and a summary mid-year update which include:

- Fund information, i.e., 'the identity of the private equity fund or funds that own the company, the senior managers or advisers who have oversight of the fund or funds, and detail on the composition of its board.'
- Enhanced reporting (as in public companies), i.e., 'a business review of main trends and factors likely to affect the future development, performance and position of the company's business and to include information on the company's employees, environmental matters and social and community issues' and 'a financial review to cover risk management objectives and policies.' Each fund should disclose:

Fund information, i.e.'a description of its own structure and investment approach and of the UK companies in its portfolio, an indication of the leadership of the firm in the UK and confirmation that arrangements are in place to deal with conflicts of interest.'

- A commitment to conform to the guidelines on a comply-or-explain basis;
- Investor information, i.e., 'a categorisation of its limited partners by geography and by type.'

Finally, the industry association should provide aggregated information on fundraising, investor profiles, existing portfolios, debt structures, changes in employment and investments by portfolio companies, performance measures for portfolio companies and

funds as well as fee structures. Altogether, these recommendations are very modest in scope and will almost certainly fail to satisfy public critics.[70]

ΠΑΝΕΠΙΣΤΗΜΙΟ ΠΕΙΡΑΙΑ

[70] S.Thomsen,p.100

ΠΑΝΕΠΙΣΤΗΜΙΟ ΠΕΙΡΑΙΑ

PART V- EUROPEAN REGULATION

A. EUROPEAN COMMISSION'S CONSULTATION ON HEDGE FUNDS

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

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

Consequently, any form of regulation aimed at hedge funds and/or hedge fund management firms would be most effective if it were well coordinated at the international level in order to avoid regulatory arbitrage and evasion. A European initiative can act as a first step towards a global consensus, but at the same time should take the competitiveness of EU-based hedge funds and hedge fund management firms into account. [71]

i) Definition of Hedge Funds in the Eurosystem

The Eurosystem sees merit in focusing on all types of leveraged and actively managed private pools of capital. In particular, leverage could be used as a distinguishing feature because it generates certain risks to financial stability which may justify targeted action. As noted in the consultation paper, a wide spectrum of private pools of capital are frequently referred to as hedge funds, although only some of them follow hedged equity investment strategies similar to those traditionally associated with hedge funds. These funds pursue a relatively unconstrained form of active asset management and usually have many similar characteristics, such as performance-based fees, investor redemption restrictions, focus on absolute returns under all market conditions, flexible investment strategies that can involve short-selling, leverage and positioning with derivatives.

[71] http://www.ecb.europa.eu/pub/pdf/other/ecconsultationhedgefundseurosystemen.pdf, 25 February 2009

However, none of these features appears to be unique to hedge funds; many of them increasingly feature in other parts of the active asset management industry and in the activities of other financial intermediaries. In practice, almost any active investment fund can be marketed as a hedge fund. Consequently, it is very difficult to clearly distinguish hedge funds from other actively managed private pools of capital.

From a financial stability viewpoint, the use of leverage is an important feature that could be used for distinguishing hedge fund-like, actively managed and leveraged private pools of capital from other active, but unleveraged funds. The use of leverage introduces certain vulnerabilities which may justify regulatory action and a targeted financial stability assessment. High leverage creates the risk of involuntary de-leveraging.

Not all hedge funds use leverage, even though they usually can, and their average leverage may not necessarily be as high as is often believed. Some hedge fund investment strategies may indeed require relatively high levels of leverage, but even then the actual levels of leverage employed typically fall short of those common in banks. Forced de-leveraging can also occur as a result of investor redemptions, but hedge funds tend to have more restrictions on investor withdrawals than traditional open-end investment funds. This equips them with more possibilities to smooth out portfolio liquidations.[72]

ii) Calls for Hedge Funds' regulation in the recent turmoil

Owing to the significance of the hedge fund sector to the major financial markets, the Eurosystem would strongly welcome more transparency and macro-prudential oversight of the hedge fund industry. Hedge funds are very dynamic participants in various financial markets. Consequently, they have been affected by – and have actively contributed to – the recent adverse developments in world financial markets.

The turmoil has highlighted how high leverage, unstable funding sources and crowded trades can contribute to adverse dynamics in market pricing patterns. Both the dynamic use of leverage and momentum-based or trend-following trading strategies can contribute to the pro-cyclical effect of hedge funds' activities on financial markets. A disruption might, for example, involve a failure of a large, highly leveraged hedge fund, a group of medium-sized, leveraged hedge funds or a large number of smaller hedge funds following the same investment strategy involving active trading in major international markets.

[72] http://www.ecb.europa.eu/pub/pdf/other/ecconsultationhedgefundseurosystemen.pdf, 25 February 2009

The lack of reliable information on aggregate investment exposures and leverage in the sector calls for the strengthening of macro-prudential oversight of hedge funds' activities and the introduction of concomitant regulatory initiatives.[73]

iii) The role of Indirect Regulation insulates the banking system from the risks of hedge fund failure

Notwithstanding its support of the current international regulatory initiatives in the hedge fund sector, the Eurosystem considers that indirect regulation has also had its merits in the past and should be further enhanced. The use of collateral and advances in risk management, facilitated in part by the introduction of the **Basel II framework**, decrease the potential losses of individual banks on their direct credit exposures to hedge funds.

However, some areas for improvement remain. Calls for enhancement of banks' risk management practices, particularly with respect to due diligence, risk measurement and risk mitigation are obvious. The Basel II framework lays ground for progress in this area.

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

iv) Prudential information authorities should have in order to monitor effectively exposures of core financial system to hedge funds

The Eurosystem would support an internationally coordinated action to collect, consolidate and publish macro-prudential information about all actively managed and leveraged pools of capital. The monitoring of the systemic impact of hedge funds would require high-quality information. Supervisory authorities should have available some tools to help them monitor the details and factors behind particular asset price movements on a close to real-time basis are limited.

In this regard, it is noteworthy that aggregate data on banks' exposures to hedge funds and other actively managed leveraged private pools of capital are not available. Moreover, there is no periodic information on aggregate leverage or broadly grouped investment exposures of hedge funds. Enhanced fund-level and consolidated information

[73] http://www.ecb.europa.eu/pub/pdf/other/ecconsultationhedgefundseurosystemen.pdf, 25 February 2009

on hedge funds' activities and the associated risks would help the monitoring and the assessment of financial stability by public authorities and also improve the effectiveness of overall market discipline.

A registration rule for hedge funds or an obligation for hedge fund managers is to inform about all managed hedge funds might need to be considered. The minimum to-be-reported fund-level information could be similar to that typically provided to hedge fund databases, including the time series of investment returns and capital under management, and be enriched with information on leverage and broadly grouped investment exposures. However, the scope, the frequency and the way of reporting merit further thinking and should also ensure a level playing field among various leveraged financial institutions that engage in hedge fund-like activities.[74]

v) The recent reduction in hedge fund trading and its efficiency effect to financial markets.

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

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

A macro-prudential approach to monitoring aggregate risk is advisable to prevent a process of disorderly de-leveraging and fire sales from threatening financial stability.

vi) Short-selling should be restricted

Authorities and the academic literature have acknowledged that short-selling plays a positive role in the market in the long run. But temporary restrictions on short-selling may be justified in specific cases, including during a financial crisis. In particular, short-sellers may target vulnerable financial institutions and may destabilise them by speculative actions, even though they would have survived otherwise.

Owing to the capacity of naked short-selling to manipulate price formation, a coordinated regulation of naked short-selling practices should be considered at international level.

[74] http://www.ecb.europa.eu/pub/pdf/other/ecconsultationhedgefundseurosystemen.pdf, 25 February 2009

Moreover, the introduction of transparency rules for short positions is advisable, to improve price formation and market conditions. In fact, disclosing short positions that exceed a certain threshold increases the amount of information contained in stock prices, because investors may correctly attribute a price drop to short-selling trading.

vii) Short-selling can threaten the integrity or stability of financial markets

The Eurosystem is of the view that restricting short-selling may be advisable at times of systemic crises, as long as such restrictions are introduced in a coordinated manner and removed as soon as normal market conditions are re-established. Such rules should apply for all market participants alike. Not imposing short-selling restrictions in systemic crises may make some financial institutions more vulnerable, thereby deepening a systemic crisis and contributing to a further loss of confidence.

Therefore, the benefits of introducing temporary short-selling restrictions in terms of containing instability may exceed their potential efficiency costs in times of systemic crisis. If all securities market participants are subject to the same regulation, there should be no case for additional oversight or regulation of hedge funds without introducing serious consideration of the unintended consequences that would likely result.

A "regulated in the EU" label could prove to be an advantage for some hedge fund-like private pools of capital. Moreover, a common EU regulatory regime would benefit market integration at the European level. Given the international character of the hedge fund value chain, a purely European response, if deemed necessary, might be most effective if directed towards asset managers and investors residing in the EU.[75]

B. The Party of European Socialists (PES) proposal for Hedge Funds & Private Equity

The Party of European Socialists published a report on private equity funds and hedge funds in spring 2007 (PES 2007) which raises objections against the private equity industry for lack of openness, short-termism, tax evasion and excessive fees. The recommendations of the report consist of legislation initiatives and guidelines aimed at greater transparency, enhanced corporate governance, job safety and a fairer tax policy. Specifically, they suggest that there should be a stronger focus on disclosure at the fund level – more information on the investment strategy, disclosure of the risk management practices, details of asset ownership and the management incentive structure. The report also suggests more direct supervision of LBOs through appropriate agencies via guidelines and direct controls. The EU should restrict owners' freedom to decide on

[75] http://www.ecb.europa.eu/pub/pdf/other/ecconsultationhedgefundseurosystemen.pdf, 25 February 2009

management pay. Other suggestions include introducing minimum capital standards, maximum levels of debt, fair advisory fees and adequate funding of pension schemes. Deductions for interest expenditure in holding, target and subsidiary companies after the buyout should be limited. Fees to fund managers should be taxed as income, not as capital gains.

The final proposal – put forward by Poul Nyrup Rasmussen, President of the PES, to the European Commission on 18 April 2008 – is motivated by three main concerns:

- **Transparency:** 'enhanced appropriate levels of transparency towards the public, investors and supervisory authorities are crucial to ensure well-functioning and stable financial markets as well as for promoting competition between market actors and products.'

- **Debt problems:** 'excessive debt required by hedge funds and private equity threatens financial stability, prejudices the realization of the long-term investment, growth and jobs agenda and is, moreover, unfairly favored in national tax regimes.'

- **Conflicts of interest:** 'conflicts of interest either arising from the business model of private equity or hedge funds or from the relationships between those vehicles and other actors in financial markets.'

It is proposed that these concerns should be remedied by a set of policy changes:

- **Mandatory capital requirements:** 'an appropriate capital requirement at the level of the entity that controls the investment of the fund or funds concerned (i.e., management firm), covering all funds regardless of their place of registration.'

- **Mandatory valuation standards:** 'precise rules on the valuation of illiquid financial instruments in order better to protect investors and the stability of financial markets.'

- **Disclosure:** 'Registration and authorization of management companies. In order to promote a well-functioning single European financial market, the Commission should ensure that management firms disclose the name and domicile of funds they control, the identity of managers, corporate earnings and bonuses, remuneration of directors, senior executives and other staff with investment responsibilities, and relationships with prime brokers.' Funds should disclose: 'general investment strategy and immediate information on any changes thereto, leverage/debt exposure, overall fees breakdown of fees (including any stock options awarded to employees), source and amount of funds raised, past performance, risk-management system and portfolio valuation methods, information on the administrator of the fund, and share of the fund contributed by the management company and its staff.'

- **Limits on leverage:** 'The Commission should introduce rules to specify the appropriate level of debt at any given time in relation to the target company introduce taxation

consequences for private equity funds in cases of excessive debt; such taxation consequences could include eliminating or reducing the tax deductibility of interest payments on the debt concerned.'

- Disclosure to limit conflicts of interest: 'The Commission should formulate rules by which to deal with the conflicts of interest between the private equity partners and the management of the target company (and any others who stand to gain from the deal). Those rules should include a requirement of public disclosure of any fees or other incentives received by directors (i.e. management board and supervisory board members) or employees of the target company.'[76]

C. PES RATIONALE FOR FUNDS' INTERVENTION

Theoretically, effective policy intervention – i.e., policy intervention that will benefit society as a whole – requires a rather stringent set of conditions to be fulfilled which are summarised in the following four points:

(1) Significant market failure;

(2) Failure of private remedies;

(3) Informed and well-intentioned policy makers;

(4) Low or moderate costs of intervention.

If the market works well, there is no reason for policy makers to intervene, so market failure is a necessary condition for welfare-enhancing government intervention. The market must fail in such a way that it produces negative returns to some stakeholders, which are significant relative to the value created by others and which can in principle be corrected by regulation that makes decision makers internalise these costs.

In a market economy, the standard assumption is that market participants can protect their own interests. Nobody forces incumbent shareholders to sell to private equity funds. Nobody forces institutional investors to invest in them or banks to lend money to them. From this perspective, issues like management compensation, partner fees or the purchase and sales prices of firms are inappropriate topics for regulation because they involve transactions with counterparts who are able to look after their own interests. Thus, the European Commission 'has acknowledged that there are no compelling investor protection reasons for national regulators to interfere in financial transactions involving professional investors who understood the risks associated with an investment' (Ferran 2007). EU internal market Commissioner McCreevy (2008) states: 'I am not in favour of heavy handed regulation to deal with these issues. Because I do not see any obvious

[76] S.Thomsen, p.101-102

market failure at EU level'. Even when shareholders have decided to dilute their control of firms to the extent that they only exercise vague control, this reflects a choice. Investors are free to suggest policies concerning compensation, takeover defences or other practices at shareholder meetings, and many of them do so. Note also that protection of minority shareholders is a major part of existing securities and company law and that the issue here is whether to add an extra layer of mandatory protection (Ferran, 2007).[77]

According to PES, below are the reasons that could lead to market failure:

- **Information problems** constitute a classical source of market failure, and a standard liberal response is therefore to ensure transparency in the belief that better informed participants are more likely to act rationally in their own interest and thus to maximise overall social welfare. The same logic can be said to underlie the calls for increasing transparency which are common to private equity regulation initiatives. In the case of private equity, the market participants often voluntarily choose to renounce the information benefits of publicly listed firms.
- **The systemic risk of high leverage** is another potential source of market failure because financial distress in a company increases the risk of financial distress in other companies. In the case of private equity, excess lending is primarily a question of bank regulation since banks provide most of the loans. Because of lax monetary policy, abundant global savings and changes in bank and accounting regulation (Basel II, fair value accounting), banks probably lent too much money up to the subprime crisis in 2007. This increased the supply of credit to private equity firms and reduced their cost of capital, but it would be wrong to say that private equity caused excessive lending. Because of their ability to call on additional funds from investors, it is not clear that private equity-owned companies are more susceptible to financial distress than other companies, but if they were, higher bank reserve requirements or similar regulation would probably be the most adequate policy instrument.
- **Labour as a third party**. The more serious advocates of regulation generally do not make the obvious claim that opportunistic private equity funds achieve their results at the expense of the employees, for example by downsizing and outsourcing to third world countries. The reason is probably that it is far from obvious that private equity funds destroy jobs, although the claim that the industry creates many jobs because it acquires many companies is clearly absurd. The most authoritative study by Davis et al. (2008)

[77] S.Thomsen, p.104-105

indicates lower employment growth in portfolio firm employment in the first three years after takeover, but slightly higher growth after that, and more new jobs created overall.

- **Tax and interest rate deductibility**. It is clear that increased leverage reduces company income tax because of deducted interest. What is much less clear is whether this involves a decrease in the tax base. For example, interest expenditure may be paid to banks and taxed as profits there, it may be passed on to their depositors (and taxed there), become part of the interest margin (and taxed as salary income) or become purchases (and income) from other suppliers. Even in the event that the interest is paid to foreign banks, this income stream will (with an unchanged balance of payment position) be cancelled out by a similar transaction in the opposite direction.[78]

Does private equity create value? There is no evidence that private equity generates net costs to society. Although industry associations like the Private Equity Council routinely claim that 'private equity firms have delivered superior returns', private equity funds and their portfolio firms appear not to outperform other investments when adjusting for financial leverage and other risk factors. As alternative investment vehicles, they presumably also provide some diversification of risk. The fact that institutional investors invest an increasing share of their funds in private equity funds is an indication that it creates value for them.

Private remedies. There are many private remedies which can insure stakeholders against potential expropriation by private equity funds. For example, voluntary best practice codes may in principle substitute for hard law. The recommendations by Walker et al. could be an example if they had more meaningful content. More importantly, stakeholders can protect their own interests directly by bilateral bargaining.

As regards creditors, banks and other creditors can demand and enforce covenants on loan contracts, and suppliers can negotiate long-term contracts or enter into strategic alliances with buyers. Shareholders can adopt takeover defences which prevent undesired takeovers, and many European firms have such defences. Thus, it is not clear that stakeholders are insufficiently protected against expropriation by private equity funds. Nor is it obvious that maintaining the status quo is a recipe for future success: in many – perhaps most – cases, dramatic changes in supply chains, work force, ownership and capital structure are required for companies and nations to thrive in global competition.

Political efficiency. The assumption that politicians are well informed and have good intentions is normally tenuous at best, but in the case of private equity it appears to be particularly doubtful. While policy should in principle be free of special interest groups to work credibly for the common good, policy makers have been unable to come up with

[78] S.Thomsen, p.105-107

satisfactory documentation for their suggested policies. It is worrisome in this regard that much public debate has been strongly partisan, for example pro-labour (PES) or pro-private equity (BVCA).

Regulation costs. For government policy to increase welfare for society as a whole, the costs of policy intervention must not exceed the benefits. Marginal changes in tax rules, voting procedures or disclosure requirements may appear to be relatively innocent, but they can easily damage the trust which capital markets – including banks, institutional investors, advisers and private equity – place in national financial systems. With open capital markets, this is fatal. Money will flow to jurisdictions that enforce freedom of contract and property rights with stable rules. Amateurish governments which stumble into regulation will no doubt do damage to their country.

The proponents of regulation have not produced a convincing case for market failure, there is substantial scope for private remedies, the policy debate is populist rather than pragmatic, and untimely intervention may undermine ratherthan improve business confidence. However, the same argument implies that there is no rationale for subsidising private equity. [79]

D. PES – THE DRIVING FORCE FOR MORE REGULATION AS REGARDS PRIVATE EQUITIES

On April 2009, the Party of European Socialists (PES), presided over by the influential Poul Nyrup Rasmussen, has to date been the driving force in Europe for more regulation of private equity and other "alternative" investment funds. The strength of feeling was emphasised in a letter from the PES to José Manuel Barroso, President of the European Commission, setting out their less than complimentary views on the draft "Proposal for a Directive on Alternative Investment Fund Managers". But far from identifying the inappropriateness of the proposed changes, the PES claims that it does not go far enough, arguing that it is "full of loop-holes which make the real regulatory effects highly ineffective".

The PES should be careful what it wishes for, because a number of its proposals could seriously impede the venture capital and private equity industry in Europe at a time when its skills and capital could most help cash-starved businesses. Employees and other stakeholders in those businesses ought to take note of the PES demands, because their impact could be very damaging.

In fact, many of the PES's complaints are said to be grounded in a need to "protect the

[79] S.Thomsen, p.108

stability of the financial system", and yet it is clear to those who have looked at the question that private equity does not pose systemic risks. There is a clear case for its exemption from measures which are seeking to address those systemic risks, and a failure to do so would mean unnecessary burdens for literally hundreds of alternative investment funds and their investee companies across the continent. Whatever the position for funds that invest in listed securities, or those which allow investor redemptions, no evidence has been presented to demonstrate that these measures would offer any greater protection if applied to venture capital and private equity funds.
The PES is not just concerned by systemic risk: it also wants greater transparency, increased protection for employees and "adequate taxation". As to the former, the private equity industry has recognised the need for more information about its strategies and investments, and has endorsed proportionate and workable rules - with suitable safeguards to protect commercially sensitive information and to ensure that compliance costs do not outweigh any benefits.

The Commission should undertake a careful cost benefit analysis, and should think hard about discriminating between companies based on their financing structure, before it brings forward any further proposals. And it is hard to see why a directive on the regulation of alternative investment funds is the right place to deal with employee rights or, still less, national tax rules.
If there are concerns about the impact of certain alternative investment fund strategies on the stability of the financial system, and if greater regulation is felt necessary to mitigate that impact, then the PES and the Commission should explain more precisely what the concerns are and bring forward carefully targeted rules to tackle them. A new set of blanket rules imposed on all but the very smallest alternative funds sounds like a misguided knee-jerk reaction which policy makers may come to regret. [80]

E. EUROPEAN COMISSION – NEW DIRECTIVE FOR HEDGE FUNDS & PRIVATE EQUITIES (AIFM)

On April 2009 the EC Commission proposed new binding legislation on "Alternative Investment Fund Managers" (AIFM), which includes the managers of hedge funds and private equity funds. This is, according to the Commission, the first attempt in any jurisdiction to create a comprehensive framework for the direct regulation and

[80] SJ Berwin, Simon Witney, "Further regulation of private equity in Europe", 30 April 2009, available at <http://www.altassets.com/private-equity-features/article/nz15739.html>

supervision in the alternative fund industry. The proposal now passes to the European Parliament and Council for consideration. The proposed AIFM Directive would:

1. Adopt an 'all encompassing' approach so as to ensure that no significant AIFM escapes effective regulation and oversight. The Directive will only apply to those AIFM managing a portfolio of more than 100 million euros. A higher threshold of 500 million euros applies to AIFM not using leverage (and having a five year lock-in period for their investors) as they are not regarded as posing systemic risks. A threshold of 100 million euros implies that roughly 30 percent of hedge fund managers, managing almost 90 percent of EU-domiciled hedge fund assets, would be covered by the Directive.

2. Regulate all major sources of risks in the alternative investment value chain by ensuring that AIFM are authorized and subject to ongoing regulation and that key service providers, including depositaries and administrators, are subject to robust regulatory standards.

3. Enhance the transparency of AIFM and the funds they manage for supervisors, investors, and other key stakeholders.

4. Ensure that all regulated entities are subject to appropriate governance standards and have robust systems in place for the management of risks, liquidity, and conflicts of interest.

5. Permit AIFM to market funds to professional investors throughout the EU subject to compliance with demanding regulatory standards.

6. Grant access to the European market to third country funds after a transitional period of three years. This should allow the EU to determine whether the necessary guarantees are in place in the countries where the funds are domiciled. [81]

[81] Blank Rome Government Relations, “EU Proposes new rules for Hedge Funds Private equity while debate on “too-big-to-fail” continues”, 29 April 2009, available at <http://www.financialreformwatch.com/tags/private-equity/>

ΠΑΝΕΠΙΣΤΗΜΙΟ ΠΕΙΡΑΙΑ

PART VI- IOSCO

A. IOSCO – HEDGE FUNDS

I) INTRODUCTION

A report entitled “Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in Hedge Funds” (the “2003 TC Report”) was published by IOSCO in February 2003. This paper identified specific regulatory issues created by hedge funds and detailed approaches for addressing the impact these issues have on retail investors.

In February 2005 the TC mandated its Standing Committee on Investment Funds (“SC5”) to update the 2003 TC Report by mapping the different approaches taken in each SC5 member jurisdiction to take account of any regulatory reforms in hedge fund regulation or in the concept of retail client as related to hedge funds. In March 2006 the TC released a Consultation Report on 'The Regulatory Environment for Hedge Funds – A Survey and Comparison'.[82]

II) GENERAL REGULATORY APPROACHES TO HEDGE FUNDS

Since the publication of the 2003 TC Report, there have been significant regulatory developments in many jurisdictions of SC5 members relating to hedge funds. It has been possible to identify at least three different general regulatory approaches to hedge funds.

Some jurisdictions accommodate more than one type of entity within their definition of hedge funds. Those jurisdictions apply different regulatory approaches that depend on certain characteristics of the fund, including retail participation and investment strategies. By grouping vehicles according to the regulatory approach of the regulator, the TC may be able to more effectively compare and analyze information about hedge funds.

1. Registered or authorized CIS engaging in hedge-fund like strategies

Most jurisdictions allow registered or authorized CIS to engage in hedge-fund like strategies. For example, some members have a specific category of CIS to accommodate CIS that engage in hedge fundlike strategies. The investment limitations imposed on these hedge funds vary from jurisdiction to jurisdiction. Some jurisdictions limit the fund’s maximum exposure to any single hedge fund and require a minimum number of underlying hedge funds. Jurisdictions also have differing approaches concerning retail participation in those CIS. Some jurisdictions impose minimum subscription thresholds or other limits relating to retail participation in the fund. For instance, in Italy, where hedge funds cannot be marketed through public offerings, sales are restricted to

[82] IOSCO, “The Regulatory Enviroment for Hedge Funds, A Survey and Comparison”, November 2006,available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD226.pdf>, p.1

"informed" investors who are able to pay a minimum amount of EUR 500,000 for each subscription.

2**. Limited hedge fund oversight by regulator**

Two jurisdictions subject certain hedge funds to limited oversight by and/or jurisdiction of the regulator but do not register or authorize the funds. Specifically, in Australia, this includes some small-scale funds that are not professionally promoted. In France, contractual funds file with the Autorité des Marchés Financiers ("AMF"), but do not request registration or authorization from the AMF. In these jurisdictions, the hedge funds are not subject to the investment limitations of ordinary CIS. However, Australia imposes certain prohibitions against offering them to retail investors, and France imposes minimum subscription thresholds and net worth or professional advice requirements on these types of funds.

3. No registration or regulation of hedge fund

Some jurisdictions have privately offered hedge funds that are not subject to registration or regulation by the regulator, such as the UK, where the funds are not registered (only hedge funds managers/advisers are authorized and regulated). Such jurisdictions impose limitations on the public offering of these funds, or otherwise restrict retail participation in the funds. In those jurisdictions, the hedge fund may be subject to anti-fraud provisions, and the hedge funds adviser may be subject to regulatory oversight or anti-fraud enforcement. Although the private hedge fund is not registered or authorized, there may be an indirect regulatory impact on this type of hedge fund if the hedge fund manager is regulated.

III) REGULATORY APPROACHES TO HEDGE FUND ADVISERS

In many member jurisdictions, hedge fund advisers are now, or soon will be, subject to regulatory oversight. In most jurisdictions advisers of hedge funds are regulated or authorized like any investment adviser located in their jurisdiction. There are exceptions: Luxembourg indicated that hedge fund advisers are not separately registered or authorized. Rather, the manager is accepted within the framework of the hedge fund (or CIS) for which they intend to act. Some jurisdictions have special requirements for hedge fund advisers or subject the registration/authorization applications of such advisers to a different type of review. For example, in Italy, the management of hedge funds and funds of hedge funds is reserved to asset management companies whose sole activity consists of managing hedge funds.

Criteria for licensing such companies in Italy include competence to carry out the functions and duties. In Luxembourg, during the process of CIS registration, investment

advisers to CIS adopting alternative investment strategies (or hedge funds) must prove that they have the appropriate level of expertise in the investment policy of the CIS. In Hong Kong the licensing requirements are the same for all CIS advisers. However, when assessing any license application, the SFC considers factors such as the risk management system, target clientele and proposed business activities of the applicant and may impose appropriate licensing conditions if necessary (*e.g.*, managers of privately placed hedge funds will not be allowed to service retail investors). Quebec has specific proficiency requirements for investment advisers and representatives of the adviser. For example, representatives of an adviser acting as an adviser in derivatives must have a minimum number of years of relevant experience in derivatives.[83]

IV) RETAIL HEDGE FUND DISCLOSURE

Generally, offers to retail clients (where allowed) must comply with minimum disclosure requirements set out by law. In 11 of the 20 responding members, disclosure for retail hedge fund offerings can be subject to heightened disclosure such as a requirement for specific warnings. For example, in Brazil, CIS that invest in derivatives must include certain legends on the cover of their prospectus. Germany, too, requires specific warnings for the sales prospectus of single hedge funds and funds of hedge funds. France also has specific disclosure requirements, including warnings to be inserted in the prospectus of certain types of CIS that engage in hedge fund-like strategies.

V) RETAIL HEDGE FUND REPORTING REQUIREMENTS

In many SC5 jurisdictions, as for other CIS, regular reporting (annual or semi-annual reports) is required to be provided for regulated hedge funds. Regular performance reports are generally required and are usually filed with the regulator. Switzerland has specific disclosure requirements for funds of hedge funds and their underlying investments. In the USA, special reporting for commodity pools also may apply to hedge funds. In Hong Kong, in addition to having to publish annual and semi-annual reports, authorized retail hedge funds have to prepare quarterly reports and must follow the SFC's guidelines for hedge funds that detail the minimum information required in these reports. In Germany, in contrast to other CIS, hedge funds are not required to disclose daily positions.

As for any other CIS, asset valuation issues do arise in hedge funds from time to time; five members reported issues or developments in this area. For example, the USA-SEC reported some problems with improper valuation of hedge fund assets. Australia

[83] IOSCO (2006), p.7-8

indicated valuation and unit pricing issues had been considered and that it anticipated issuing guidance for all CIS on this topic. The U.K indicated that it had encountered problems with valuation for hedge funds but noted the jurisdictional issues caused by the fact that the fund operators and administrators were offshore.

Eight of the surveyed jurisdictions have a valuation methodology policy for hedge funds managers. In addition, it is interesting to note that some jurisdictions have a specific regulatory framework or requirements for prime-brokerage (*e.g.*, France, Germany, Hong Kong, Switzerland, UK, USA).

VI) EXAMINATION AND ENFORCEMENT

Some jurisdictions indicated that the number of enforcement actions or complaints relating to hedge funds was not high. The data on the level of complaints and enforcement actions involving hedge funds was difficult to compare due to the different perceptions of “hedge fund” and the varying regulatory treatment. Some jurisdictions have new regulations so enforcement data is not available (e.g., there were no on-shore hedge funds prior to the new regulations). Other jurisdictions do not separate enforcement data by type of CIS so no enforcement data relating to actions involving hedge funds was available. Other jurisdictions indicated enforcement actions or complaints relating to any regulated CIS are generally low in their jurisdiction.

Switzerland reported actions involving offshore funds. As explained above, most members provided limited statistics on lawsuits involving hedge funds. Most hedge funds (i.e., those that are registered or authorized as CIS) and advisers are subject to audits by their regulator, including during the registration or licensing process.

VII) GENERAL OBSERVATIONS FROM SURVEY RESULTS

1. While there is no formal legal definition of the term “hedge fund” in any SC5 jurisdiction, each jurisdiction has views on what a hedge fund is. Based on those viewpoints, the TC observed common regulatory approaches to hedge funds among member jurisdictions based on broad similarity in these approaches. The groupings of common regulatory approaches may allow the TC, in any future work relating to hedge funds, to collect and analyze data more precisely.

2. Some jurisdictions are developing regulations that are specifically for hedge funds that are registered or authorized as CIS. Moreover, even though in many jurisdictions some hedge funds may not be regulated, those who operate, sponsor, or advise on hedge funds are subject to regulation in many instances. In addition, regulations regarding disclosure, advertising, recordkeeping and reporting may be applicable.

3. Few jurisdictions reported any significant retailization of hedge funds at this point in time. However, this snapshot of current data should not be used to extrapolate future trends; some regulators reported that they anticipate greater retailization in their jurisdictions in the future.

4. The extent of fraud relating to hedge funds varies in the member jurisdictions (including among the types of hedge funds such as private hedge funds versus registered hedge funds). The absolute number of fraud complaints is presently not high although some regulators perceive a risk of greater fraud in the future as further retailization occurs. However, in this respect it is important to be mindful that the collected data represents a "snapshot" of the time that the survey was conducted. Surveyed member regulators continue to monitor for fraud in connection with hedge funds.[84]

VIII) IOSCO FINALIZES PRINCIPLES FOR THE VALUATION OF HEDGE FUNDS PORTFOLIOS

In November 2007, the International Organization of Securities Commissions (IOSCO) has publicly released its Principles for the Valuation of Hedge Fund Portfolios.

Michel Prada, Chairman of the IOSCO Technical Committee, said: "Hedge fund asset management techniques are utilized in all asset classes and across numerous jurisdictions. The valuation issues relating to investment portfolios and their importance, particularly in current market conditions, to existing and potential investors are the same across a wide range of jurisdictions.

"The chief aim of the principles is to seek to ensure that a hedge fund's financial instruments are appropriately valued and, in particular, that these values are not distorted to the disadvantage of fund investors. IOSCO believes that investors will ultimately benefit if hedge funds follow these principles."

The Principles describe techniques which should strengthen the controls, oversight and independence of the valuation process. They emphasize the importance of written policies which are implemented consistently and regularly reviewed. These measures should strengthen the valuation process thereby making it more likely that the resulting valuation is appropriate. The Principles may also be helpful for institutional and sophisticated investors in assessing the quality of the valuation framework within hedge funds.

[84] IOSCO (2006), p.9-10

The 9 Principles are:

1. Comprehensive, documented policies and procedures should be established for the valuation of financial instruments held or employed by a hedge fund.

2. The policies should identify the methodologies that will be used for valuing each type of financial instrument held or employed by the hedge fund.

3. The financial instruments held or employed by hedge funds should be consistently valued according to the policies and procedures.

4. The policies and procedures should be reviewed periodically to seek to ensure their continued appropriateness.

5. The Governing Body should seek to ensure that an appropriately high level of independence is brought to bear in the application of the policies and procedures and whenever they are reviewed.

6. The policies and procedures should seek to ensure that an appropriate level of independent review is undertaken of each individual valuation and in particular of any valuation that is influenced by the Manager.

7. The policies and procedures should describe the process for handling and documenting price overrides, including the review of price overrides by an Independent Party.

8. The Governing Body should conduct initial and periodic due diligence on third parties that are appointed to perform valuation services.

9. The arrangements in place for the valuation of the hedge fund's investment portfolio should be transparent to investors.[85]

B. IOSCO – PRIVATE EQUITIES

I) CONSULTATION PAPER

In November 2007, IOSCO published a Consultation Paper prepared by the Technical Committee in relation to Private Equity. The paper had two objectives. Firstly, to identify those issues generated by the activity of the private equity industry which potentially create risks that impact on IOSCO's objectives and principles. Secondly, having identified these relevant issues, it set out the next steps IOSCO proposed to take.

This Final Report reports on the feedback received during the consultation period and the next steps that IOSCO will be taking as a result. The report is structured into the following sections: a feedback statement outlining the responses received to the consultation and IOSCO's reaction to these points, the final version of the private equity report and non- confidential responses received during the consultation.

[85] IOSCO/MR/011/2007, "IOSCO finalizes Principles for the Valuation of Hedge Fund Portfolios", 19 November 2007, available at <http://www.iosco.org/news/pdf/IOSCONEWS110.pdf>, p.1-3

a) Feedback Statement

Non-confidential responses were submitted by the following organizations to IOSCO Technical Committee (TC) consultation entitled *Consultation Report: Private Equity*. The deadline for comments was 20 February 2008.

Association Française de la Gestion financière (AFG), Association of Investment Companies (AIC), British Private Equity and Venture Capital Association (BVCA), European Association of Public Banks (EAPB), European Private Equity and Venture Capital Association (EVCA), International Banking Federation (IBFed), International Investment Funds Association (IIFA), University of Bristol, Zentraler Kreditausschuss.

The Technical Committee took these responses into consideration when preparing this final report.

b) Comments received

In general, responses to the consultation paper were supportive of the TC's work and were broadly in agreement with the findings and conclusions of the report. Identification of issues posed by private equity markets to capital markets in general and IOSCO's stated aims and objectives. The responses received generally agreed that the consultation report had appropriately identified seven issues arising from private equity business which merited consideration against IOSCO's objectives.

Respondents also generally agreed with the report's analysis that six of the issues identified could be considered of relevance to IOSCO's stated objectives and principles of securities regulation. Based on the responses received the TC does not propose to make amendments to its report with respect to the issues it considers are posed by private equity to capital markets in general or which of these it considers are relevant to IOSCO's objectives and principles.

c) Consideration of future work on private equity for IOSCO's future work program.

The report identified two pieces of work that the TC proposed to take forward. These are a survey of the complexity and leverage of capital structures employed in leveraged buyout transactions; and the analysis of conflicts of interest which arise during the course of private equity business.

Several responses commented that a number of the issues identified were also pertinent to other areas of capital market activity, an issue that the TC had highlighted within its report. Respondents therefore agreed with the TC that it should be mindful of work already conducted within IOSCO and other regulatory organizations so as not to duplicate effort or create unnecessary burden in these areas. However, the majority of

responses were broadly supportive of the two pieces of work identified and agreed these were appropriate to take forward.

d) **The potential benefits of private equity business.** A number of respondents commented that the report had focused on the potential negative aspects of private equity business and had not outlined any of the benefits that this sector offered to capital markets. Potential advantages put forward included: investment diversification; the elimination of market inefficiencies; and beneficial effects on economic growth.

The TC acknowledges that private equity, like many other forms of investment, offers potential benefits to capital market participants. However, this report is intended as an objective assessment of the impact of private equity on securities market regulation. The TC therefore considers that the report should focus solely on the identification of regulatory issues.

II) EXECUTIVE SUMMARY

In its 2007 work programme, the IOSCO Technical Committee mandated a Task Force on private equity to conduct a preliminary review of private equity markets with a view to identifying any suitable issues which could be addressed through future IOSCO work. The Task Force approached this by: identifying a set of issues which private equity markets may pose to capital markets; analyzing which of these issues may be pertinent to IOSCO's stated objectives and principles; and forming recommendations for the Technical Committee as to what further work might be considered within the IOSCO and international regulatory framework.

This analysis has identified seven specific issues relating to private equity markets that have been raised as potential risks to financial markets, of which six are relevant to IOSCO's objectives. These are outlined in detail in the main section of this report. In considering further work, to avoid any duplication due regard have been given to work that has already taken place in IOSCO and other international fora. The Technical Committee has therefore agreed to pursue the following two pieces of work in future work programmes:

A survey of the complexity and leverage of capital structures employed in leveraged buyout transactions across relevant IOSCO jurisdictions. This would allow assessment of the potential impact that the default of large private equity portfolio companies could have on the efficient operation of related public debt securities markets and any systemic issues which may arise as a result. As this work would involve input from leveraged finance providers and will include issues of interest to banking regulators, the Technical Committee will recommend this work for consideration within the Joint Forum; and

Analysis of conflicts of interest which arise during the course of private equity business and the controls utilised across relevant IOSCO member states which aim to provide appropriate levels of investor protection. Key areas of focus will be public-to-private transactions and the listing (or subsequent re-listing) of private equity portfolio companies. These situations potentially have a heightened impact on public securities markets and investors. This work will incorporate both private equity firms and market intermediaries and will focus on identifying conflicts which are present, or are unique, within the context of private equity transactions as they relate to public markets.

When defining this work, due regard will be given to existing IOSCO work in areas such as disclosure, corporate governance, debt market transparency and conflicts of interest, in order to avoid duplication of previous efforts. The Technical Committee has also mandated that consideration will be given to participation by industry and investors throughout this process.

At the meeting of the IOSCO Technical Committee on 7 February 2007 it was agreed that a Task Force would be assembled in order to conduct a preliminary review of the private equity sector. This was communicated externally via the publication of the Committee's work program in March 2007. This decision reflected the growing importance and influence of private equity within global capital markets. The purpose of the Task Force was outlined as being to assess the issues posed to securities markets by private equity, determine which are relevant to IOSCO's mandate, and recommend appropriate work that could be taken forward within the IOSCO framework.

III) OVERVIEW OF ISSUES POSED BY PRIVATE EQUITY TO CAPITAL MARKETS

This section outlines a number of issues posed by private equity markets that are considered pertinent to capital markets in general. The following section will consider their relevance to IOSCO's objectives.

Increasing leverage: A relatively benign economic environment in recent years until the middle of 2007, specifically with low global interest rates and narrow credit spreads, appears to have encouraged a growth in lending associated with leveraged buyout (LBO) activity. Empirical evidence from certain jurisdictions has suggested that leverage levels employed in such transactions in those jurisdictions are increasing. Where such leveraged activity is growing, it may place increased pressure on the future capacity of the companies involved to service their debt. Under certain conditions, this may increase the probability of these companies ultimately experiencing financial distress and default. Given that this topic is typically associated with larger LBO deals, and therefore bigger

portfolio companies, this may have negative implications for lenders, purchasers of the debt, orderly markets and conceivably, in extreme circumstances, financial stability. In some circumstances, public securities markets may also be affected as, following a public to private transaction, some firms retain the listing of previously issued debt securities.

Market abuse: The significant flow of price sensitive information in relation to private equity transactions, as with other merger and acquisition (M&A) activity, creates potential for market abuse. In some markets, this flow may increase with greater size and complexity in transactions and when more parties become involved. If a jurisdiction does not have sufficient market abuse oversight mechanisms in place, market abuse can undermine investor confidence in a market and affect the liquidity investors are willing to provide to issuers in the future.

Conflicts of interest management: Private equity transactions can present material conflicts for a number of parties including private equity firms, investors, target portfolio companies and market intermediaries, many of which are present in other types of M&A activity. Some parties can, and do, take on multiple roles with respect to the same transaction, and there also may exist conflicts between these parties' advisory and proprietary activities. Where public companies are involved, regulators and investors therefore emphasise the controls that firms have in place to ensure that these potential conflicts do not undermine investor confidence in the marketplace.

Transparency: Current and prospective private equity investors typically receive a substantial level of disclosure from private equity firms. However, critics have raised a number of issues regarding transparency related to PE firms:

Standardisation of valuation and performance reporting – Industry standards, such as the International Private Equity and Venture Capital Valuation Guidelines, exist and, whilst widely used, have not been adopted consistently across the industry. Currently, it can be difficult for investors to make objective comparisons across private equity firms in order to determine their optimal investment strategy. While this issue does not touch on the regulation of public markets, it has been argued that a lack of consistency might undermine investor confidence in private equity firms;

Disclosure to wider stakeholders – Investors in private equity transactions demand detailed and commercially sensitive information. However, the wider market receives relatively little information on the activities and performance of funds, portfolio companies and private equity firms. While this asymmetry of information is topical in certain jurisdictions, this report does not consider it to be an issue specifically relevant to the regulation of securities markets at this time; and

Retail involvement – Private equity is currently a wholesale focused sector in the majority of jurisdictions. If direct retail investor access is sought, then securities

regulators in individual jurisdictions will need to assess the adequacy of their regulatory environment to deal with this type of business.

Overall market efficiency – As with most investors, the private equity sector naturally targets firms with the highest expected return on invested capital. Once significant gains have been realised, firms look to exit their investments either via an initial public offering, a secondary buyout by another private equity investor or a strategic corporate merger. Therefore private equity ownership can form an important part of the development lifecycle of a firm. However, it has been argued that this trend has the potential to create issues for some public securities markets including:

Public investors losing access to firms during the period of their development when they are subject to maximum growth before they are returned to public ownership. This has the potential to result in a public market consisting of mature companies or volatile and risky firms in which private equity firms are not interested. It can also be noted that private equity investors tend to focus on acquiring "undervalued" or poorly performing issuers, and thus private equity acts as a powerful mechanism for ensuring that managers of public companies are competent and seek to maximize shareholder value;

In some jurisdictions, concerns exist that high volumes of private equity activity may have a detrimental effect on the quality, size and depth of public markets and, potentially, the fair and efficient operation of those markets; and

Governance in public firms focusing on short term share price levels, not long term strategic growth, in order to protect against becoming a take-over target.

Others note that private equity practices provide distinct benefits to a capital market. These benefits include widening the availability and source of capital, increasing the accuracy of company valuations (factoring in their growth potential), enhancing the efficiency of corporate capital structures and facilitating corporate development. On a more micro level, benefits could also include avoidance of bankruptcy or other legal restructuring up to and possibly including governmental intervention or, more positively, providing financing and executive skills lacking in current management. In light of these issues, public bodies may therefore need to consider the effective calibration of incentives to participate in public or private markets when considering the appropriateness of incumbent regulatory, taxation and competitive regimes.

Diverse ownership of economic exposure: The duration and potential impact of any credit event or downturn may be exacerbated by structural issues which make it difficult to identify who ultimately owns the economic risk associated with, typically, a leveraged buyout and how these owners will react in a crisis. These concerns may arise out of the extensive use of opaque and complex risk transfer practices such as assignment and sub-participation, together with the increased use of credit derivatives (which may not be

confirmed in a timely manner). The entrance of new types of market participants utilizing different business models adds further complexities. Differences in international insolvency practice and legislation may also add to uncertainty as issuance increasingly takes place cross-border. Some argue that these factors may create opacity which could damage the timeliness and effectiveness of workouts following credit events and could, in an extreme scenario, undermine otherwise viable restructurings.

Market Access: Private equity firms typically raise funds from institutional investors and financially sophisticated individuals; there is currently little direct retail investment. However, some investment entities have sought public listings which, alongside venture capital trusts and private equity investment trusts, will provide some retail exposure to the market risks these firms undertake. In certain jurisdictions, this can also bring the private equity firm itself under a separate regulatory regime from non-listed firms. Other examples include the offering of hybrid securities to retail investors as part of a private equity transaction. Depending on the structure of the offering and the disclosure regulations of the jurisdiction in which the offering is made, this can create opacity in terms of the true risk associated with such securities and the how they are positioned in the case of corporate failure.

IV) SPECIFIC RELEVANCE OF ISSUES TO IOSCO'S OBJECTIVES AND PRINCIPLES

It is recognized that not all of the issues outlined above are directly relevant to IOSCO's remit with respect to the securities regulation. IOSCO has set three objectives of securities regulation, which are:

- The protection of investors;
- Ensuring that markets are fair, efficient and transparent; and
- The reduction of systemic risk.

These objectives are supported by the 30 principles which provide guidance as to IOSCO's recommendations for the desirable attributes of the regulatory framework for public securities markets within a jurisdiction. In order to determine which of the outlined issues are relevant to IOSCO's mandate, and are therefore an area for potential mitigation work within the organization's regulatory framework, this report presents the results of analysis of the outlined issues against these objectives and principles.

It is recognized that differing regulatory regimes, structures and objectives amongst its members may mean that certain areas may not be specifically applicable, as described,

within individual regulatory jurisdictions, or potentially fall within the remit of a number of regulatory and self-regulatory organizations.[86]

ΠΑΝΕΠΙΣΤΗΜΙΟ ΠΕΙΡΑΙΑ

[86]IOSCO, "Private Equity, Final Report", May 2008, available at <www.iosco.org.library/pub/docs/pdfIOSCOPD274.pdf>

ΠΑΝΕΠΙΣΤΗΜΙΟ ΠΕΙΡΑΙΑ

PART VII- CONCLUSION

PRIVATE EQUITY

Since private equity is relatively new, it has yet to find its proper niche in society. In the long run, this will happen more or less automatically if markets are left to their own devices. For example, it is possible that restructuring will emerge as the main competitive strength of private equity funds.[87] It is expected that in jurisdictions where the trend towards an increase in private equity deals and mega multiparty transactions can create pressures on national lawmakers, it is conceivable that there will be a mixture of reform responses focusing on tighter disclosure requirements for private equity funds and general partners, increased corporate governance and investor protection measures, and a change in approach to valuation and the taxation of carried interest.[88]

Private Equities have a crucial role to play in the Schumpeterian creative destruction which generates economic growth. But not all companies need downsizing and restructuring. It is also possible that private equity funds will come to be seen as intermediaries, which orchestrate ownership changes – i.e., reallocate companies to 'best owners'. In that case, the focus could be on succession in family firms. Or they may have a role to play as growth accelerators, which would also make them more suitable for some firms than others. In principle, they may even become extinct as we enter a period of low growth and high interest rates.

It is difficult to foresee their future precisely. Under these circumstances, trial and error by the markets will no doubt be better than politicians in defining the future of private equity. The costs of policy changes are high, and policy makers have insufficient information and inadequate incentives to regulate efficiently. Efficient regulation requires more convincing arguments, better information and less partisan views.

However, in current circumstances the pressure for regulation may be so strong that some kind of intervention is inevitable. Under these circumstances, the best feasible (least costly) alternative may to advocate standard liberal solutions like transparency and tax neutrality. The private equity business itself has already taken some steps in this direction (cf., the Walker Report and similar work in other countries). Arguably, transparency also constitutes the core of the PES proposal, which makes very direct and specific recommendations with regard to disclosure but is much less precise with regard to rules on leverage and capital requirements.[89]

[87] S.Thomsen, p.108

[88] J.McCahery and E.Vermeulen, "Private Equity and Hedge Fund Activism: 'Explaining the Differences in Regulatory Responses", *European Business Organization Law Review 9: 535-578*, p. 41-42

[89] S.Thomsen, p.109

HEDGE FUNDS

Perhaps the best outcome from the global financial crisis is that "regulate" is no longer a dirty word. Governments worldwide realize once again that loans require collateral. Hedge funds and investment banks require regulation, and it is the proper role of government to provide it.[90] Counterparty risk management practices such as the use of collateral and haircuts have proven effective in limiting the exposure of trading counterparties, notably prime brokers.

From a financial stability perspective, regulation should not try to prevent hedge fund failures as these events remind sophisticated investors of the risks they are taking and limit moral hazard. Indirect regulation by prime brokers and market discipline by creditors, counterparties, and investors have resulted in reduced hedge fund leverage, improved funding liquidity, increased disclosure, and improved counterparty risk management practices. These mechanisms have been tested and found effective during the current financial crisis.

We argue that direct regulation of hedge funds may not be feasible and is not likely to be effective, due to the delays with reporting and processing the information. Hedge funds that wish to avoid regulation can choose to locate offshore. Position reporting to avoid crowded trades may encourage moral hazard, while greater transparency on positions could inadvertently lead to a decline in liquidity, making markets more volatile and increasing financial instability in times of stress.

Finally, we argue that greater regulation of LCFIs that own prime brokers is required. Prime brokers play an important role in the indirect regulation of hedge funds, monitoring their hedge fund clients and using collateral and haircuts to minimize the impact of a hedge fund failure. But the prime brokerage industry is highly concentrated, and the top prime brokers are owned by LCFIs that employ high degrees of leverage, engage in aggressive trading strategies, and are exposed to the same risks as hedge funds. Greater competition by prime brokers to attract valuable hedge fund business may erode indirect regulation, leading to lower collateral, more favorable credit, and less monitoring of hedge funds. Direct regulation of LCFIs should buttress this potential transmission channel by setting minimum standards for collateral and haircuts to hedge fund clients.[91]

As for hedge funds, we find that in recent years lawmakers have pursued a number of different mechanisms to prevent activist investors from exercising significant influence over corporate decision making, including (1) transparency and disclosure rules relating to large shareholdings; (2) shareholder voting and communication rules; and (3) special

[90] J. Schnoor , 'Global financial and environmental crises', ENVIRONMENTAL SCIENCE & TECHNOLOGY 9, December 1, 2008

dividends paid to shareholders to compensate them for their long-term investment in a company's stock.

For example, standard-like strategies are used to protect public investors and management by ensuring the reliability of disclosures about large holdings of voting rights of companies. Insofar as a disclosure obligation covers also the goals of the investment and source of funds for the acquisition of shares, we can expect that investors will be reasonably protected. Where capital markets are very well developed and protected, as in the US and UK, investor protection rules contain provisions mandating any person or group that owns more than 5% of a public company's stock and decides to act in concert, to file a disclosure statement. These jurisdictions have the advantage of having a regulatory framework that contains some obstacles to acting in concert but do not prevent traditional institutional investors or activist funds from coordinating their actions against a target company. The emphasis, for example, on adopting stringent measures may appear necessary to some lawmakers in order to protect investors when there are insufficient enforcement mechanisms to which investors may turn in order to protect their interests.[92]

[91] M. Kinga, P. Maier , page 1-2.
[92] J.McCahery and E.Vermeulen, p. 41-42

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