*Oskar Ode*
*Phone: +46- 8-7878198*
*Oskar.Ode@fi.se*

*Financial Stability Department*
*Maria Strömqvist*
*Phone: +46-8-7870228*
*Maria.Stromqvist@riksbank.se*
*Dnr 2009-151-AFS*

# Response by Finansinspektionen and Sveriges Riksbank to the Consultation by the European Commission on Hedge Funds, 30 January 2008

The European Commission is conducting a review of the regulatory and supervisory framework for all financial market actors in the European Union. The European Parliament has raised questions about the limited extent to which hedge fund managers and funds are subject to regulation. Concerns expressed relate in particular to the impact on the stability of the financial system and the lack of transparency of hedge funds in relation to regulators and other financial market actors. The responses to and conclusions from the consultation will serve as the basis for an appropriate regulatory initiative.

Financial stability issues are of core interest to Finansinspektionen (the Swedish Financial Supervisory Authority) and Sveriges Riksbank, and thus, this memorandum presents our response to the consultation.

Questions and responses

1. ***Hedge funds focus on delivery of absolute return and use leverage, short-selling and derivatives to achieve this purpose. Their investor base is institutional or other sophisticated investors and they are often domiciled offshore. Hedge funds are exempted from many investment protection and disclosure requirements. Are these characteristics sufficient to distinguish hedge funds from other actors in financial markets (especially other leveraged institutions or funds)? If not, what other/additional elements should be taken into account? Do their distinct features justify a targeted assessment of their activities?***

    § Given that the term “hedge fund” is a collective term for many types of investment funds with different investment strategies, it is difficult to clearly distinguish a hedge fund from another investment fund. One way to deal with the issue is to define a regular investment fund by the UCITS directive. All other funds are then classified as alternative investment funds, a group in which hedge funds would be included. This classification would however include many funds that in different jurisdictions would not be considered hedge funds due to different regulatory regimes. In Sweden the large majority of non-UCITS funds are not considered hedge funds or alternative investment funds.

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

   § A purely European response will be ineffective as a hedge fund often is domiciled in one country and the manager registered in another. Given the dominance by US hedge funds in the industry, an international perspective must be taken and greater cooperation with the US is necessary. However, greater European harmonisation may facilitate cooperation with the US.

3. ***Does recent experience require a reassessment of the systemic relevance of hedge funds?***

   § A reassessment of the systemic relevance of hedge funds should consider three aspects and be put in relation to other institutional investor groups. First, the share of assets under management. Second, the size of individual funds and the concentration of assets between funds. And third, the share of trading activities in a specific market. Since hedge funds only have a small proportion of the assets under management in the financial industry their systemic influence arises from the use of leverage. Hence, any analysis of the systemic risks of hedge funds should focus on leverage. In this context it should be noted that UCITS funds are allowed leverage of 2 times capital which is greater than the leverage of the average hedge fund according to the consultation.

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

   § Although there is nothing that eliminates the risk of hedge fund failures, the recent period has shown the great influence prime brokers have on hedge funds. For example, stricter credit conditions have had a major impact on hedge fund leverage. Thus, requirements on prime brokers should still be an effective way to regulate hedge fund activity and their use of leverage as well as ensuring efficient risk management by banks. Banks should be asked to convey more detailed information on, for example, off balance sheet instruments bought by hedge funds and loans given to funds. This information would be useful to ensure an efficient indirect regulation of hedge funds.

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

   § The impact on the financial system can be monitored through the investments in hedge funds by large regulated institutional investors. Information on their exposure to alternative investments could easily be reported and would give the authorities an idea of the size of the exposures to hedge funds within the financial system. By monitoring the use of leverage, authorities will also monitor the contribution of hedge funds to asset movements. If this information is not sufficient, the need for a supervision level more similar to that of UCITS funds would be desirable. Such a level of supervision would most likely require more detailed reporting, such as hedge fund holdings. However, this may not be realistic because of the complexity of holdings and high turnover of transactions. In addition, hedge funds are often considered as leading financial innovation and it will be difficult, if possible, for prudential authorities to monitor a hedge fund's activities on a detailed basis. This will most likely not be possible even through additional funding but would require different methods of supervision. Supervisory authorities face this constraint in other areas as well. The contribution of hedge funds to asset price movements will be a function of their share of managed capital, their degree of leverage and their share of traded instruments. The influence of hedge funds will thus differ depending on market conditions and how liquid the market in question is.

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

§ Given that the de-leveraging in the financial system has been a broad de-leveraging, partly due to increased risk aversion among investors, these questions are not specific for hedge funds. In most market conditions, hedge funds have a positive effect on price formation, liquidity and market efficiency. In general, reduced trading volumes have a negative impact on price formation. Hence, the impact on financial markets from the reduction in hedge fund trading is related to their share of trading activity in the markets and the volumes traded.

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

§ Short-selling constraints make it more difficult for financial participants to intensify negative market movements but it also makes it harder to protect long positions through short positions and to use arbitrage strategies. It is unreasonable to expect investors to refrain from speculating against mispricing in certain market conditions and that a large mispricing should be allowed to persist. Also, banning short-selling in stressed market conditions can have a negative effect on liquidity in a time when it is most needed. Hence, short-selling constraints will have a negative impact on market efficiency and price formation. Also, given that short positions can be mimicked by using financial instruments and derivatives, the effect from a constraint is obviously limited.

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

§ First of all, a thorough analysis is necessary to determine if there is a need for tighter market controls and rules on short-selling. Second, the question applies to financial market participants in general and is not specific to hedge funds. Hence, if needed, general abuse disciplines rather than tighter controls for hedge funds should be the relevant issue. It is possible that short-selling might lead to distorted price signals if they in a market squeeze can be used to exercise unreasonably large market impact. In the long-run, however, the negative effects from banning short-selling clearly outweigh the positive. Increased transparency of short-selling in combination with standardised clearing and central counterparties could reduce threats to the integrity or stability of financial markets while not restricting short-selling.

9. ***How should the internal processes of hedge funds be improved, particularly with respect to risk management? How should an appropriate regulatory initiative be designed to complement and reinforce industry codes to address risk management and administration?***

   § Regulators can complement industry codes on new issues of liquidity, counterparty, custodian and settlement risk with guidelines and encourage a discussion on the importance and best practice of risk management in hedge funds by, for example, hosting round table discussions with market participants. A harmonised framework for hedge funds could also be considered. In Sweden domestic hedge funds are regulated based on the same framework as UCITS funds. The experience of using the same framework has been positive.

10. ***Do investors receive sufficient information from hedge funds on a pre-contractual and ongoing basis to make sound investment decisions? If not, where do the deficiencies lie? What regulatory response if any is needed to complement industry codes to make a significant contribution to the transparency of hedge fund activities to their investors?***

   § Given that hedge funds target sophisticated investors, these investors should be able to make sure they receive enough information to make sound investment decisions without the intervention of regulators. Also, more transparency is not always better. The transparency of a market depends on the specific market microstructure and the type of investors trading in that market. For example, the use of and need for transparency is different between the stock, bond and FX markets. A hedge fund's strategy is the core in its business and is therefore often kept secret. Hence, there is a trade-off between transparency to investors and keeping a competitive edge. The balance between the two is best determined by hedge funds and their investors. However, hedge funds aim at retail investors at an increasing rate. In Sweden this is dealt with through requiring the same pre-contractual and ongoing information from hedge funds as from UCITS funds. This means that hedge funds have to fulfil the same transparency requirements. This also applies for foreign, including offshore, hedge funds that market their funds in Sweden. Finansinspektionen publishes risk data for non-UCITS funds on its website as one way of enhancing information.

**11. *In the light of recent developments, do you consider it a positive development to facilitate the access of retail investors, subject to appropriate controls, to hedge fund exposures?***

- Retail investors should not be denied the possibility of hedge fund exposure. It is necessary that retail investors receive clear and comprehensive information on the risks relating to investing in hedge funds. One way to facilitate that would be through creating a common regulatory regime such as the UCITS directive. For hedge funds to stay unregulated their focus should continue to be on institutional investors and high net worth individuals.

| | |
|---|---|
| Finansinspektionen | Sveriges Riksbank |
| Erik Saers | Mattias Persson |
| Head of Department | Head of Department |