Investment Management and Real Estate

European Commission moves towards regulating hedge funds

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There are two main regulatory initiatives. In its November 2008 declaration, the G-20 set out its proposals to stabilise financial markets. As a result of this, the International Organisation of Securities Commissions (IOSCO) formed three task forces to review short selling; unregulated financial entities; unregulated markets and products.

The likely impact

While these regulatory initiatives vary in scope, their practical effect is likely to be to create a three-tiered industry structure – within Europe, at least.

- Regulated hedge funds, governed by UCITS III legislation, have weathered the financial crisis well. They are likely to be allowed to continue to be marketed to a wide range of investors.
- Unregulated hedge funds that accept certain limits on their activities will be allowed to market to investors falling into specific definitions of sophistication and net wealth. However, they will have to provide more transparency in their investment strategies, accept a capped level of leverage and comply with a capital requirement in the form of a liquidity buffer.
- Hedge funds that do not comply with these requirements will form the third tier. They will only be able to market to specific groups of people.

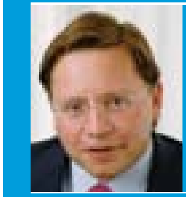
Looking forward, this will cause the hedge fund industry to fragment. The less leveraged strategies such as equity long-short will become increasingly accepted by not only the institutional market but also retail investors. More specialist strategies such as macro or distressed debt may remain unregulated and able to market to a similar group of investors as is currently the case. Finally, the highly leveraged arbitrage funds will find the size of their potential market curtailed.

European Commission moves towards regulating hedge funds

In response to a Parliamentary report in September 2008, and against the backdrop of the ongoing crisis, the European Commission consulted on hedge funds activities with a view to potential regulatory action before June 2009. It identified five key areas for stakeholder comment: definition of hedge funds, hedge funds contribution to systemic risk, short-selling, transparency and disclosure to investors and supervisors.

PricewaterhouseCoopers, in responding to the consultation, highlighted, inter alia:

- Hedge funds cannot be defined by unique and distinctive criteria, and yet a clear definition would be necessary for direct regulation of hedge funds. From an EU perspective, prudential requirements for prime brokers which use leverage may provide an alternative, particularly as most hedge funds are not domiciled in the EU.
- The extent and the nature of hedge funds' contributions to the current financial crisis is difficult to determine in the absence of adequate empirical data.
- Tailored but sound risk management practices need to be implemented by all actors in the industry, including fund managers, fund administrators, custodians, etc. Where these practices rely on industry codes, effective enforcement mechanisms need to be in place.
- Regulators would benefit from enhanced disclosure on hedge fund trading strategies, amount of leverage used with the portfolio, types of financial instruments used and exposure concentrations.
- Retail investors should be allowed access to hedge funds provided they are sufficiently informed of the risks they are undertaking.



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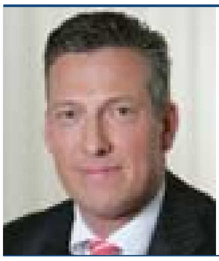

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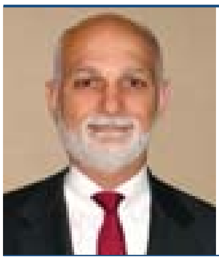

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