Submission from the Hedge Fund Standards Board (HFSB) to the European Commission public consultation on hedge funds

1. Introduction

The European Commission has launched a wide-ranging public consultation on policy issues arising from the activities of the hedge fund industry, with the aim of developing an appropriate regulatory response. The findings will feed into a high-level conference in late February, and will serve as the basis for European input into the parallel reflections on hedge funds at the G20 level.

The Hedge Fund Standards Board (HFSB) has been set up to act as custodian of the Best Practice Standards published by the Hedge Fund Working Group in 2008 and to promote conformity to the Standards. It is also responsible for ensuring that they are updated and refined as appropriate. Over 30 managers from the UK and abroad have already committed to the process of the HFSB, and more managers are expected to sign up to the Standards in 2009.

Hedge funds, in common with many other market participants, have been severely affected by the current crisis and the loss of confidence in markets as a whole. The Hedge Fund Standards Board believes that hedge fund managers play an important role in global markets and is prepared to work with policy makers to help improve the regulatory environment which will enable the industry to fulfil its mission.

The Hedge Fund Standards Board herewith comments on the questions raised by the European Commission.

2. HFSB detailed responses

2.1. Scoping the issues

(1) Are the above considerations 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?

The term hedge fund was originally used to describe a type of private investment fund that uses leverage to magnify returns, uses short selling to limit market risk, and charges investors a performance fee. This description still fits many hedge funds but by no means all.

There is no legal or regulatory definition of a hedge fund in the UK and the range of funds covered by the term is very wide.

The first step in clarifying characteristics is to distinguish between the hedge funds (the legal vehicle where the assets are held) and hedge fund managers, the asset managers that manage the fund.[1]

There are a series of characteristics that are often attributed to the hedge fund industry, both in terms of management techniques and common structures used:

Characteristics	...but...
Total return objective*	• not all funds explicitly pursue absolute (uncorrelated) returns
Leverage*	• not all strategies use leverage
Short selling	• not all managers do engage in short selling
Employing derivatives*	• not all hedge funds use derivatives • an increasing number of "traditional" long only funds nowadays use derivatives in managing their portfolio as well
Trading more actively than traditional managers	• not all managers trade with high frequencies: Some invest in (illiquid) securities to hold on to them for longer periods
Accessible only to institutional / sophisticated investor base (ie high investment limits)	• some "traditional" long only managers employ hedge fund type strategies (eg 130/30 funds use short selling) • some hedge funds are accessible to retail investors (eg. if they are listed) • some jurisdictions allow retail access to hedge funds
Have a fee structure, which heavily incentivises good performance	• some Long only retail funds exhibit performance based compensation in their fee structures as well
Funds are domiciled in offshore domiciles, such as the Cayman Islands, Bermuda, British Virgin Islands	• some hedge funds offer access to their investment management techniques via onshore structures

* Characteristics highlighted in the Consultation Paper on Hedge Funds of the European Commission

However, the table already illustrates that none of these characteristics alone is a sufficient condition to define a hedge fund or hedge fund manager, nor are these all necessary conditions to define a hedge fund or hedge fund manager. Some will share some or all or many of these characteristics, others do not. Therefore, the definition proposed by the European Commission (as well as the additional characteristics illustrated above) might not be sufficient to distinguish hedge funds from other actors in financial markets.

The European Commission rightfully points out that the trading strategies of hedge fund managers have often been replicated elsewhere, for example in the proprietary trading activities of investment banks. This indeed highlights that many of the issues arising in the context of hedge funds (and addressed in the Hedge Fund Standards) are applicable to other areas of the financial sector as well.

Given that many of the characteristics exhibited by hedge funds/hedge funds managers are also at the heart of the activities of other market participants (such as investment banks, long only managers, etc), it is not advisable to have a distinct set of regulations applicable to an arbitrary subset of market participants.

[1] It is the hedge fund managers that are subject to the Hedge Fund Standards.

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

As in many other areas of financial services, activities in relation to hedge funds are global.

However, before assessing whether a "European response" will be effective, it is necessary to identify what are the exact issues/concerns that a policy response is seeking to address.

The HFSB sees two distinct areas where the need for a policy response can be assessed, a) behavioural/micro prudential issues and b) systemic issues. In addition, matters relating to the competitiveness of European financial markets also play a role in this assessment.

a) Behavioural /micro prudential issues

The majority of the European Hedge Fund Industry (here: the manager) is located in London and falls under the regulation of the UK Financial Services Authority (FSA) in the same way as other traditional (long only) asset managers. Therefore, our assessment focuses in the first case on whether the regulatory environment in the UK is suitable for addressing behavioural / micro prudential issues, and second, the global dimension thereof.

The FSA's regulatory framework is principles based and therefore creates an environment where hedge fund managers have constantly to be certain that their actions do not contravene those principles, regardless of whether specific detailed rules exist. The FSA regulatory framework also addresses concerns in areas such as valuations, disclosure and market integrity and has reporting requirements applicable to hedge fund managers (and all other regulated firms). This is complemented by thematic visits, and direct relationship management with larger hedge fund managers. The FSA has also a mechanism for assessing issues around financial stability (which are addressed further below).

Many of the areas addressed by FSA also lie at the heart of the best practice Standards of the Hedge Fund Standards Board (HFSB). These standards cover the areas of disclosure, valuation, risk management, governance and shareholder conduct. The Standards are anchored in FSA's Principles, and thereby provide a translation of these into a framework of discipline for hedge fund managers. The FSA has welcomed the publication of the Standards, and has recently declared that it sees them "as a very constructive addition to the wider regulatory architecture." [2]

So far, hedge fund managers accounting for more than 50% of industry Assets Under Management in the UK have voluntarily committed to the HFSB approach. A large number of managers are expected to follow suit over the coming 12 months. This industry-driven initiative, based on the comply or explain principle and relying on self-certification and enforcement by investors, follows a well-tested model which developed in the UK in the context of Corporate Governance codes of conduct. It should help enhance confidence in the hedge fund industry and the financial sector as a whole.

The HFSB interacts closely with the FSA to identify and discuss areas of potential concern. This can also include identifying areas where governmental regulation cannot provide the level of practical

[2] The regulator's view of hedge funds and hedge fund standards: Speech by Hector Sants, Chief Executive, FSA, Hedge 2008 Conference, 22 October 2008.

detail that the industry requires, and where the Hedge Fund Standards can fill that gap and act as the market-based extension of FSA's regulation.

Given the comprehensiveness of this regulatory architecture, the HFSB does not see a need for large scale reform of regulation for hedge fund managers in the UK. In addition, it is our conviction that the industry has behaved in a responsible manner in the UK, and has proved both its resilience and the overall benefits of its demanding economic model.

However, we are aware of the current concerns of regulators and policy makers and we stand ready to cooperate, in order to identify areas where refinement and adaptation of current regulation may be needed.

The second part of the answer addresses the global dimension of regulation of behavioural /micro prudential issues. Clearly the US is where the largest part of hedge fund activity resides, and it is important to distinguish the UK regulatory regime - where managers have to go through a thorough registration process - from its US counterpart, where there is no obligation to be registered and hedge funds are mostly exempt from regulation. However, the new US administration has already indicated that it intends to strengthen its regulatory oversight of the hedge fund sector.

In developing a global approach and level playing field, responsibility should lie with IOSCO, FSF and the G20 to determine where enhancement is needed, and where further convergence is required.

At the level of industry best practice and Standards, the HFSB will contribute to the discussion around global convergence of hedge fund standards, as recommended by the G20. The HFSB has already begun to work closely with its counterparts in the US, the Investors Committee and the Asset Managers Committee of the Presidents Working Group, to delineate a global approach to Hedge Fund Standards, also involving various industry associations including AIMA and the MFA.

b) Systemic issues

This is addressed in the subsequent section, Systemic risks.

2.2. Systemic risks

(3) Does recent experience require a reassessment of the systemic relevance of hedge funds?

The current crisis has demonstrated that the hedge fund industry has been relatively resilient in the face of the recent extreme volatility in financial markets. Clearly, the downsizing of global financial markets has caused hedge funds to shrink as well, since they are now a mainstream segment of the markets and could not be immune to the dramatic correction that has taken place.

The European Commission highlights several areas where systemic concerns could potentially arise in the context of hedge funds:

- Hedge fund failure destabilising a bank
- Pro-cyclical effect of hedge funds on asset markets (including market pressure resulting from unwinding of illiquid positions in times of distress)

Hedge fund failure destabilising a bank

A bank failure caused by a hedge fund has been a major concern of many policy makers prior to the financial crisis. However, it is important to highlight that current financial stability concerns do not originate from the hedge fund sector, but from the banking sector. In fact, the causality has been in the opposite direction: the troubles which many banks experienced, culminating in the bankruptcy of Lehman Brothers, inflicted significant losses on hedge funds and their investors. Since they hold substantial assets in large banks (in particular, broker dealers) hedge funds are significantly exposed to the risk of broker-dealer bankruptcy.

The European Commission has rightfully pointed out in its consultation paper that losses and failure of hedge fund managers are borne directly by investors and that the most direct transmission channel from hedge funds to the wider financial system has been through the potential consequences of a hedge fund failure for systemically relevant institutions, notably prime brokers which have counterparty exposure to hedge funds.

This illustrates that the risk (though not necessarily systemic risk) for the banking sector arises only in instances where banks face credit risk vis à vis hedge funds, eg from direct lending, derivatives and other transactions and this is where regulatory efforts to assess issues relating to financial stability should lie.

This is what the UK FSA seeks to assess via its Prime Broker surveys of banks' exposure to hedge funds, including drill downs into outliers and assessment of the banks' counterparty risk management capabilities.

The HFSB believes that this approach is robust, but would be happy to engage with regulators if there is a need to enhance the current regime. In addition, global cooperation between regulators could be enhanced to develop a global "risk dashboard", aggregating information on risk taking of banks (and not only with respect to hedge funds) from various regulators.

Illustration: "Madoff and financial stability"

The recent Madoff scandal (note: the breadth of Madoff's activities (including brokerage, custody, administration and fund management) would not necessarily qualify as a hedge fund manager) illustrates how losses are ultimately borne by investors, with no financial stability implications: Losses of USD 50BN have been reported in the Madoff scandal, but there has been no systemic issue arising in the context of this major fraud, since all losses have been ultimately borne by end investors and a minor portion by banks, who have provided leverage to some of the vehicles providing access to Madoff.

In contrast, losses of this magnitude hitting an individual bank (or the banking sector of a country) can give rise to severe dislocations, such as freezing of interbank funding markets and a retail investor run on banks , which could ultimately lead to state guarantees, public capital injections, nationalisations, etc.).

Pro-cyclical effect of hedge funds

The Consultation paper raises concerns about the pro-cyclical effect of hedge funds such as inflation of asset price bubbles, and a subsequent acceleration of the deleveraging process, thereby increasing market volatility.

a) Inflation of asset price bubbles

The HFSB believes it is important to highlight that investment techniques employed by hedge funds such as short selling actually help to dampen bubbles. For example, short selling helps to smooth out excessive peaks in market prices and accelerate price corrections, while at the same time buying at times when prices are falling (i.e., to cover the short position). This actually reduces volatility in the markets, thereby reducing price volatility and ultimately reducing the cost for companies to raise capital in the markets.[3,4]

More generally, the HFSB has seen no evidence supporting the hypothesis that Hedge Funds have contributed to asset bubbles.

b) Accelerating the deleveraging process

The second concern raised in the consultation paper relates to deleveraging and "hedge funds being forced to sell assets into fragile markets", driven by investor redemptions and tighter credit conditions/deleveraging.

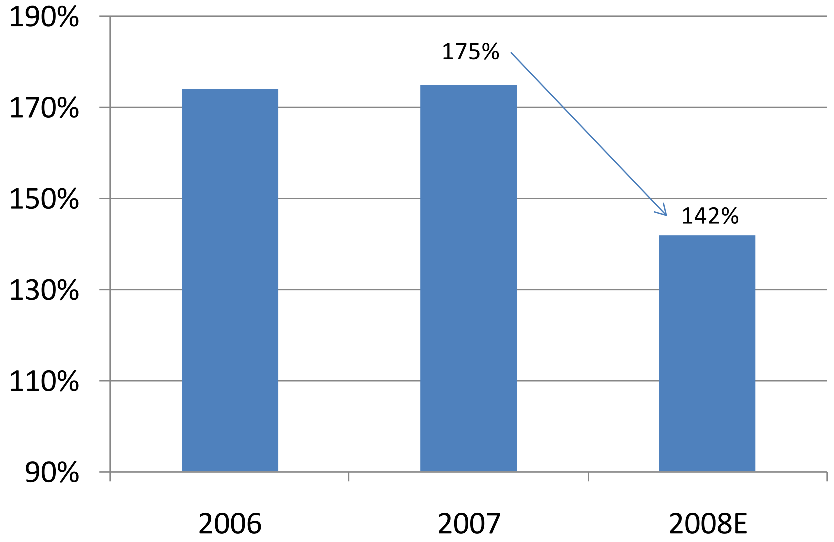
Similar to long only asset managers, hedge fund managers have to sell assets if their investors wish to redeem their monies. However, in contrast to classic long only funds, some hedge funds use leverage, which amplifies the required asset disposal to meet the redemption request.

However, it is important to note that leverage in hedge funds is much lower than in other financial institutions – in particular banks, where leverage reaches 3000% and in some instances up to 6000% – and it declined significantly in 2008 (see Illustration below), as credit conditions became more onerous. In addition, most hedge funds do not provide daily liquidity, but monthly or less frequent liquidity, thereby allowing for an orderly unwinding of positions.

[3] Charoenrook and Daouk find strong evidence that the relaxation of short selling restrictions results in a significant decline in the cost of capital (Charoenrook/Daouk, Vanderbilt University/Cornell University, 01/2005: A Study of market-wide short selling restrictions, p. 16

[4] Beyond actually dampening bubbles, short selling brings many additional benefits to markets, such as more efficient price discovery, enhanced liquidity, reduced transaction cost and revenue enhancement for long investors.

Illustration: Average Gross Leverage as of Mid-November, 2008[5]



The HFSB acknowledges that the leveraged nature of some hedge funds makes their cash positions more sensitive to sudden market distress than that of liquid long only funds. Therefore, the Hedge Fund Standards propose various approaches to assess liquidity risk, including stress testing of the fund's liquidity position by simulating severe market shocks, increases in collateral requirements, cancellation of credit lines, investor redemptions etc.

Despite the recent strain in markets and severe hedge fund redemptions (which have in instances resulted in gating and suspension of redemptions at hedge funds), the HFSB has seen no evidence of disposals by hedge funds resulting in disorderly markets.

Conclusion on systemic relevance

This assessment highlights that the systemic dimension comes into play at the interface between the hedge fund industry and the banking sector and illustrates that regulators need a two-pronged approach to global financial regulation. Banks, insurance companies and other financial intermediaries with large-scale retail operations must be highly regulated, for prudential reasons, to protect depositors and investors, and to prevent systemic risks.

By contrast hedge funds rely on sophisticated investors, with an increasing share of institutional monies. These are knowledgeable and sophisticated – or they have the resources to hire knowledgeable and sophisticated advisors – and therefore do not need the protection of regulators in the way retail investors do. Clearly, hedge funds have to abide by the general requirements of integrity and respect for market rules.

In addition, hedge funds are held to very high standards of performance by investors. Every year, hundreds of hedge funds are liquidated, due to investor dissatisfaction. In parallel, every year hundreds of new funds are created, to launch innovative strategies and test the skill of new

[5] Source: Bernstein Research, Equity Portfolio Strategy: The Fund Deleveraging and Redemption Debate, November 21, 2008, Survey results (consistent with recent IMF survey, IMF World Financial Stability Report)

managers. This dynamic process guarantees that the market weeds out mediocre performance and that those who survive create value for their investors.

It is therefore imperative that the regulatory environment for hedge funds does not impair the dynamism of financial innovation and the ability of the sector to provide investors with all options for risk taking. This is very different from the regulatory requirements for banks or insurance companies and creates a different set of challenges.

(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?

As illustrated in the previous answer, the indirect approach via Prime Brokers is the best and most effective way to look at the interface between the hedge fund industry and the banking sector, and the risks entered by the banking system in relation to hedge fund activities. The HFSB would be pleased to engage with policy makers and regulators to discuss how the current approach (eg as practiced by the FSA) can be enhanced in specific areas, and how a meaningful global approach could be developed. The HFSB does not see the need for alternative approaches.

(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?

As suggested above, authorities and regulators have sufficient tools to monitor risks arising from hedge funds for the core financial system.

2.3. Market efficiency and integrity

The questions raised in the consultation paper in the context of market efficiency and integrity focus predominantly on short selling, and potential risks arising in this context. The following section provides an introduction to short selling and its role in global financial markets, assesses the situation in September 2008, when short selling bans were implemented, and then addresses the specific questions raised in the consultation paper.

2.3.1. Introduction

Short selling plays an important role in global financial markets and brings many benefits to the global economies, including investor protection against market volatility, increased liquidity for all market participants, more efficient price discovery, dampening of price bubbles and prevention of other market inefficiencies, and ultimately more efficient capital allocation.

The ability to sell stocks short makes investing far more attractive at times of stress because it encourages investors to stay in the market even when prices are declining. By hedging their positions through short sales, investors can continue to hold other stocks with the aim of achieving absolute returns. Without the option to short sell, investors are much more likely to withdraw from a declining market, accentuating the market contraction during major crises like the present one.

The recent short selling ban has brought this investment management and hedging instrument to the forefront of the public debate. The wider public debate has been accompanied by widespread misconceptions about short selling and doubts around its usefulness.

The HFSB would like to contribute to this debate in order to provide a perspective on the benefits of short selling, to offer an analysis of the impact of the short selling ban on markets, and to discuss the effectiveness of a short selling ban as an instrument of regulatory intervention in markets in times of distress.

2.3.2. The role of short selling in markets

We believe it is important to highlight the broader function short selling performs in capital markets and the benefits it brings to the economy as whole given the widespread misconceptions in the current public debate around short selling and its benefits.

1. *Efficient price discovery:* The ability to sell short allows markets to incorporate new information more quickly, in particular pessimistic information in the price discovery process. This results in more robust prices. Short sellers can be seen as "market detectives" who spot excessive valuations early on and provide a corrective force, thereby preventing misallocation of capital in the economy.

2. *Dampening of bubbles:* Short-sellers can help dampen price bubbles, by smoothing out excessive peaks in market prices and accelerating price corrections, while at the same time buying at times when prices are falling (i.e., to cover the short position).

3. *Reduced cost of capital to companies:* Short selling activity (i.e., selling when everyone else is buying) reduces volatility in the markets, thereby reducing price volatility and ultimately reducing the cost for companies to raise capital in the markets.[6]

4. *Viability of capital raising instruments:* Short selling is inextricably linked with the viability of certain fundamental capital raising instruments, such as convertible bonds; without short selling, convertible bonds become much riskier to investors; the result is in effect to shut down a very important channel for raising capital, particularly for financial institutions.

5. *Enhanced liquidity and reduced transaction cost:* Short-selling increases the depth of the market, thereby reducing the spreads (=the transaction cost to all market participants). Academic research examining short selling practices in 111 countries confirms that market quality improves (ie greater liquidity, less volatility) when short selling is allowed. [7]

   > *Current example: Research shown in the subsequent section (Figure 2) demonstrates how spreads have increased since the introduction of the short selling ban, hurting all investors.*

6. *Revenue enhancement for long investors:* Investors holding long positions can lend out their securities to short sellers and earn a fee from this activity. This allows pension funds, for example, to enhance their returns and ultimately benefit their investors.

---

[6] Charoenrook and Daouk find strong evidence that the relaxation of short selling restrictions results in a significant decline in the cost of capital (Charoenrook/Daouk, Vanderbilt University/Cornell University, 01/2005: A Study of market-wide short selling restrictions, p. 16

[7] Also confirmed by empirical research by Charoenrook and Daouk, Vanderbilt University/Cornell University, 01/2005: A Study of market-wide short selling restrictions

> In conclusion, short selling is a crucial component of an efficient capital market. Without it, investors will be far less confident about remaining invested and markets will be far less efficient. A good example of the inefficient capital allocation that can occur when markets operate without correction is the wasteful investment in overpriced securities that is observable during bubbles. The dot.com bubble of 1998/2000 or the house price bubble of 2005/2007 provide ample evidence of this. Short selling is a crucial mechanism to burst bubbles, and sometimes even preventing them from happening.

Notwithstanding these benefits, we are aware that there can be cases of market abuse in the context of short selling. One such activity is called "short and distort", where false rumours are spread causing a stock to fall. This is similar to market abuse activity in the context of long positions such as "pump and dump". All such market manipulation is already illegal under current EU legislation (Market Abuse Directive), and the HFSB has set out best practice standards to help hedge fund managers comply with these legal and regulatory requirements. It is important to note that the best practice approaches identified by the HFSB might well merit consideration for adoption by all investors in addition to hedge funds.

2.3.3. The situation in September 2008

This section provides an overview of events since 18 September 2008, starting with an overview of the short selling ban across many markets and an analysis of the subsequent impact on markets.

The short selling ban

From midnight on Thursday 18 September, regulators throughout Europe restricted the short-selling of shares in financial companies. The measures were taken "to protect the fundamental integrity and quality of markets and to guard against further instability in the financial sector."[8] Regulators in US, Canada, Australia, India, Taiwan, and Dubai also took similar actions in response to the crisis.

The approach and restrictiveness of the short-selling regimes varies by country. The following table provides a short overview, however, in many instances, the bans have been lifted since, sometimes in combination with enhanced disclosure requirements.

[8] FSA statement on short positions in financial stock (FSA/PN/102/2008), 18.09.2008

Table 1: Overview on short selling regimes in select countries

	UK (FSA)	US (SEC)	Spain (CNMV)	Germany (Bafin)	Australia
What is prohibited:	Active creation or increase of net short positions	Covered and uncovered short selling	(Uncovered short selling already prohibited)	Uncovered short-sales	Total ban on (covered and uncovered) short-selling
Scope	Financial stock	Financial stock		Select financial stock	All stock
Disclosure requirement (yes/no), threshold	Yes, all net short positions in excess of 0.25%	Yes, for institutional investors of all new short positions, no thresholds	Yes, >0.25%	No	Yes, daily of all short positions, no threshold
Duration	16 Jan 2009	Lifted 8 Oct (for covered), but ban on uncovered prevails (ban was not on uncovered shorting per se, but rather failures to deliver)		31 Dec 2008	27 Jan 2009 (fin. stock); 30 days for non-financial stocks, has been extended

The UK FSA has stressed that it sees short-selling as a legitimate investment technique in normal market conditions.

Impact of the short selling ban

(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?

Research indicates that the short selling ban enacted by regulators has had a series of short term implications for markets:

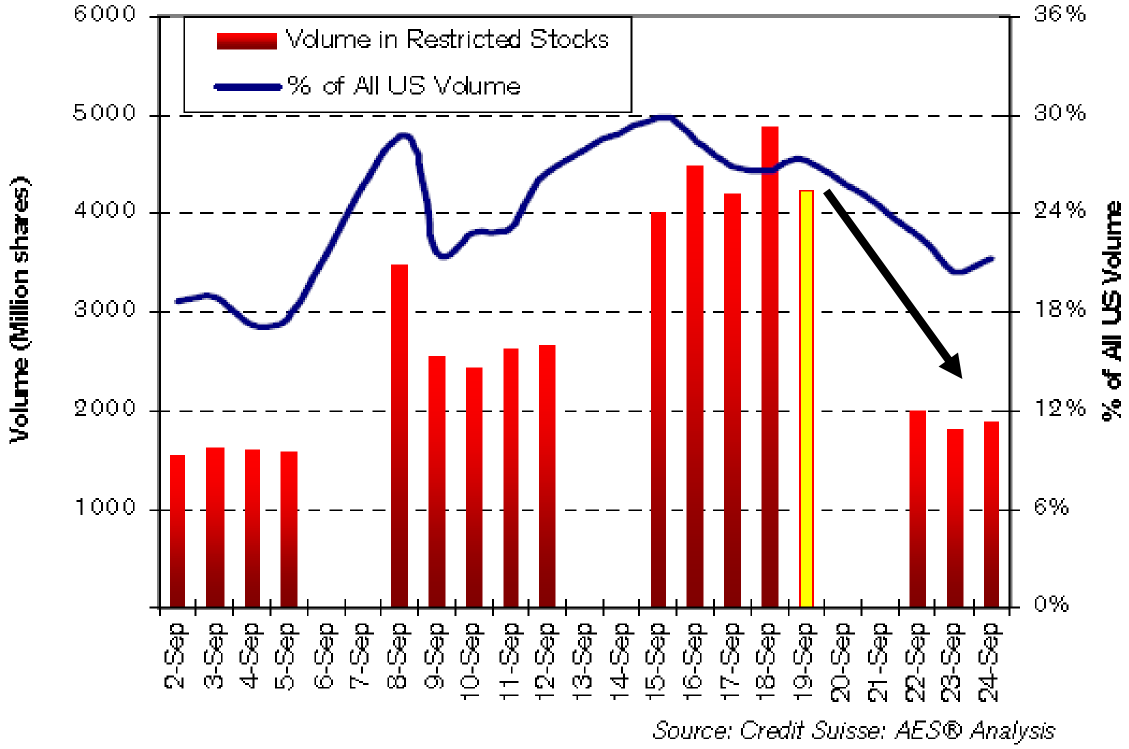
- Reduced liquidity in affected stocks
- Higher trading costs in affected stocks
- Volatility of affected stock has not significantly reduced

Reduced liquidity in affected stocks

Research[9] based on US market data indicates that liquidity in affected stocks has significantly decreased since imposing the ban.

[9] Credit Suisse, What happened when Traders' Shorts Were Pulled Down, 30 September 2008

Figure 1: Trading volume

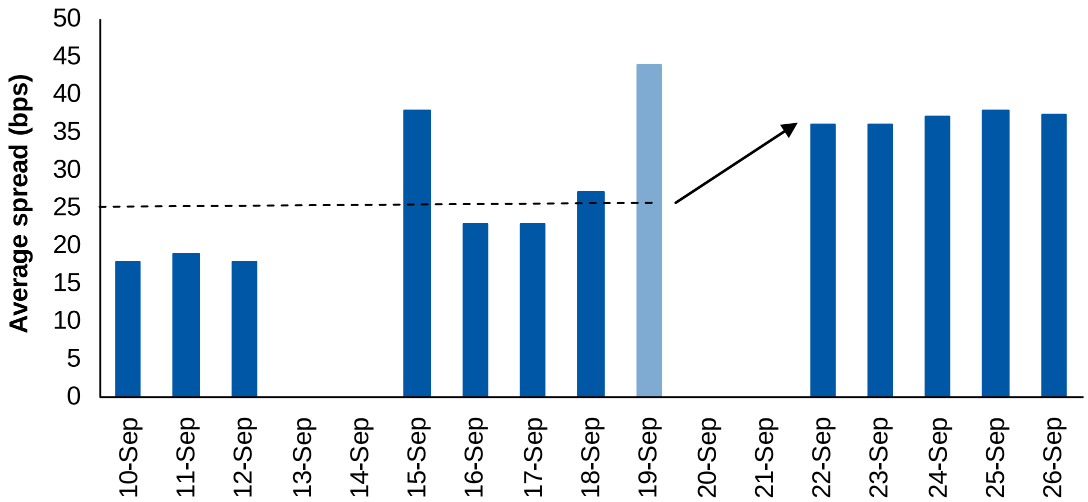


Source: Credit Suisse: AES® Analysis

Higher trading cost in affected stock

The cost to trade restricted stock has increased when comparing pre and post short selling ban spreads. [10]

Figure 2: Trading cost



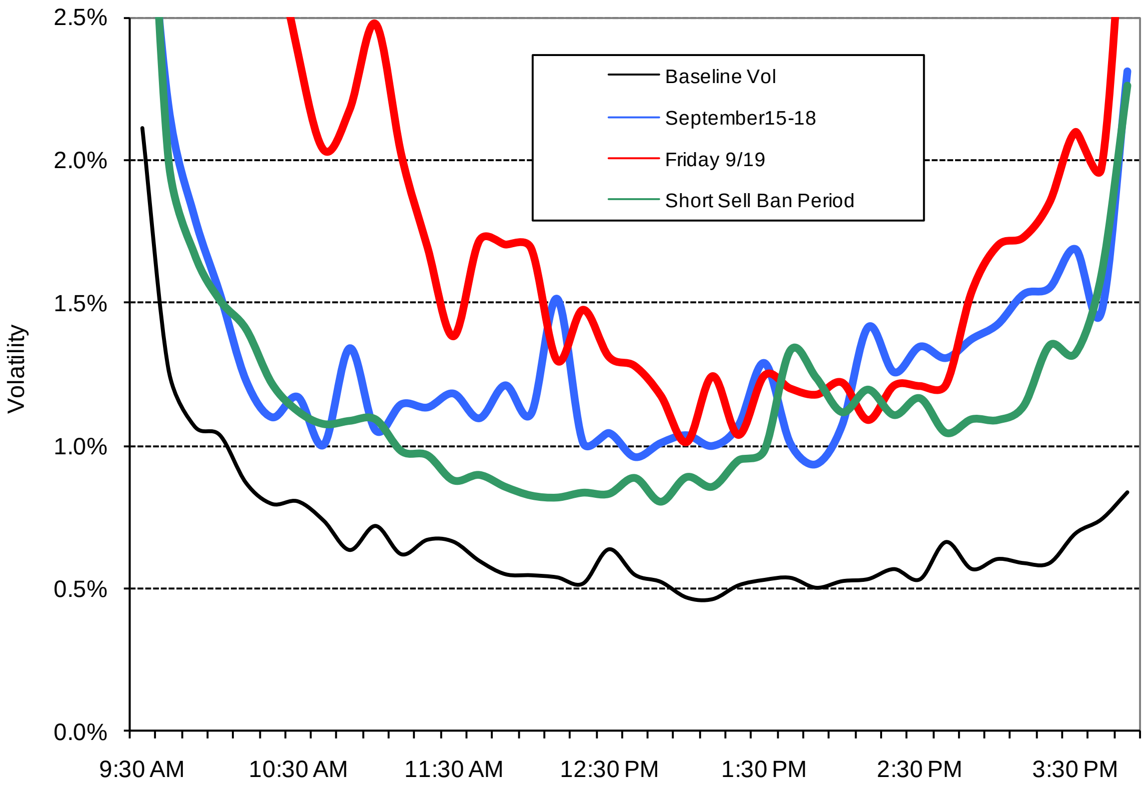
Source: Credit Suisse Portfolio Strategy/ AES® analysis

[10] Source: Credit Suisse Portfolio Strategy / AES Analysis, 09/2008, based on US market data.

Volatility of affected stock has not significantly reduced

The short selling ban was enacted during a "crisis" week dominated by gloomy headlines, and it coincided with the expiration of index options and futures, a market event that usually incites enhanced volatility. As demonstrated by research in US markets, volatility spiked directly after the ban (19 September). Though that volatility has since reduced, it continues to remain above the baseline levels (measured as the normal August to the first two weeks of September). Many researchers do not believe there is conclusive evidence that the restrictions on short selling were effective in reducing volatility.

Figure 3: Intraday volatility of stocks subject to the short selling restrictions (10 min intervals)[11]



In many markets, a technical short term rally was observable in stock directly impacted by the short selling ban immediately after it was imposed. Simultaneously, a drop was observable in other stocks (i.e., those constituting the long position in a hedge transaction). This price correction induced by regulatory activity has led to winners and losers in an arbitrary manner (regulatory hazard). Ultimately, this adds to the "risks" investors face in financial markets. Market participants will be wary of future regulatory intervention, and this ultimately increases the cost of capital to companies.

[11] Source: Credit Suisse AES Analysis

Is a short selling ban a useful instrument for regulators in times of distress such as the current crisis?

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

We have no doubt that regulators are aware of the overall benefits of short selling as outlined above, and are also aware of the explicit and implicit damage a ban on short selling of certain stocks inflicts on markets and the economy as a whole. Recent statements by regulators have also confirmed that short selling is not seen as the root cause of the current crisis, but that falling bank stocks are instead the consequence of the broader problems in the banking sector and a general loss of confidence which ultimately could only be resolved through massive government intervention.

With or without short selling, the public realized that banks were extremely vulnerable, due to their exposure to risky assets far beyond what their reduced levels of equity would support. Since this lack of confidence very quickly led to bank runs and given that several financial institutions filed for bankruptcy, investors shied away from bank stocks for reasons which have nothing to do with short selling. We acknowledge that when regulators and politicians are coping with an emergency brought on by fears of a meltdown of the banking system (i.e., a run on the banks caused by plummeting bank stocks), extreme measures may be warranted. In such instances, however, it is important that regulators and politicians assess the adequacy of a specific measure to resolve a given problem ("Does the measure help to restore order to the markets?", "Does the measure prevent bank stocks from falling further?", Does the measure clearly facilitate vital capital raising activities?" or ultimately "Does the measure reduce the probability of a run on the bank?").

We believe that there is insufficient evidence to justify a short selling ban on the grounds that disorderly markets were due to short selling:

- We do not find evidence that a disorderly market existed in banking/financial stocks in the first place; even assuming such a situation did exist, we do not believe there is any evidence to show that short selling was the root cause of it. Research confirms that hedge funds (which engage in short selling, opposite to "long only" funds) were net buyers of financial stocks in the weeks up to 12 September, while long only players were heavy sellers of financial stocks (see Figure 4, based on flow data from UBS)[12]. In addition, no single bank was included in the Top 10 FTSE 100 stocks on loan (as a percentage of all outstanding stock) on 8 September (see Appendix A)
- Despite an immediate short term rally in banking/financial stocks, the shorting ban has not prevented banking/financial stocks from falling further since (see Figure 5).
- Finally, the "what if" assessment of whether the measure has prevented a run on banks (e.g., on Friday 19 September and the subsequent week end) cannot be answered given that the alternative scenario is not known.

  We acknowledge that the short term rally on Friday 19 September might have contributed to re-establishing some confidence in the banking sector in the short term, particularly among the broader public. This technical reaction was short lived, however, and not a reflection of

[12] Source: UBS Investment Research, European Equity Strategy 12 September 2008 (based on internal UBS flow data)

an actual mispricing of banking/financial stocks, as demonstrated by the subsequent further drop in financial/banking stocks. One can clearly argue, then, that markets were not disorderly in the first place and that there was no inherent mispricing. Unfortunately, the shorting ban and the perceived easing of the pressure due to the subsequent rally has given rise to a widespread criticism of short sellers and hedge funds in particular. We believe these claims to be completely unfounded and detrimental to the reputation of financial markets as a whole.

Figure 4: Net flows (4 weeks average prior to 12 September) by sector and fund type

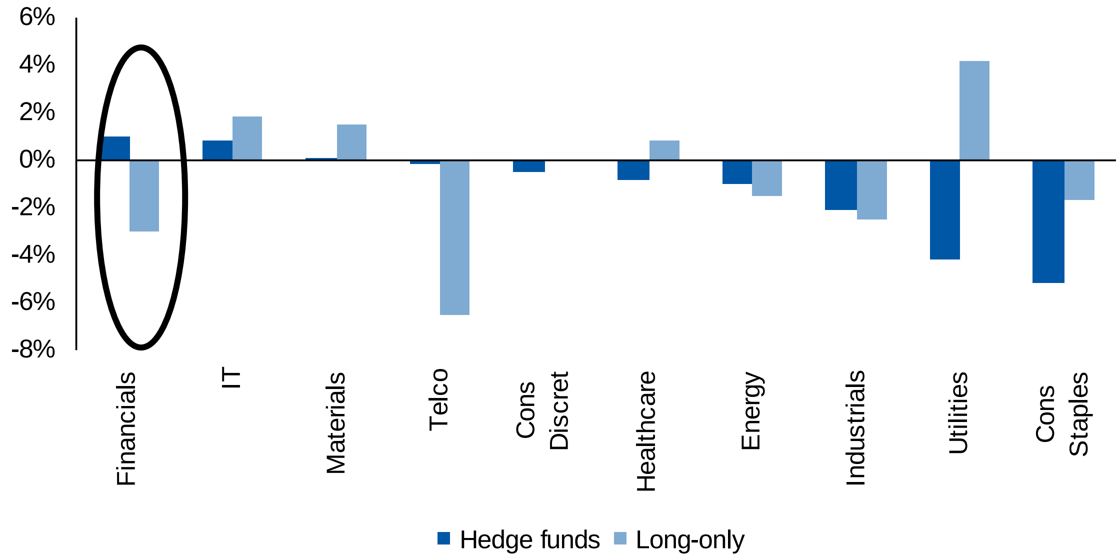
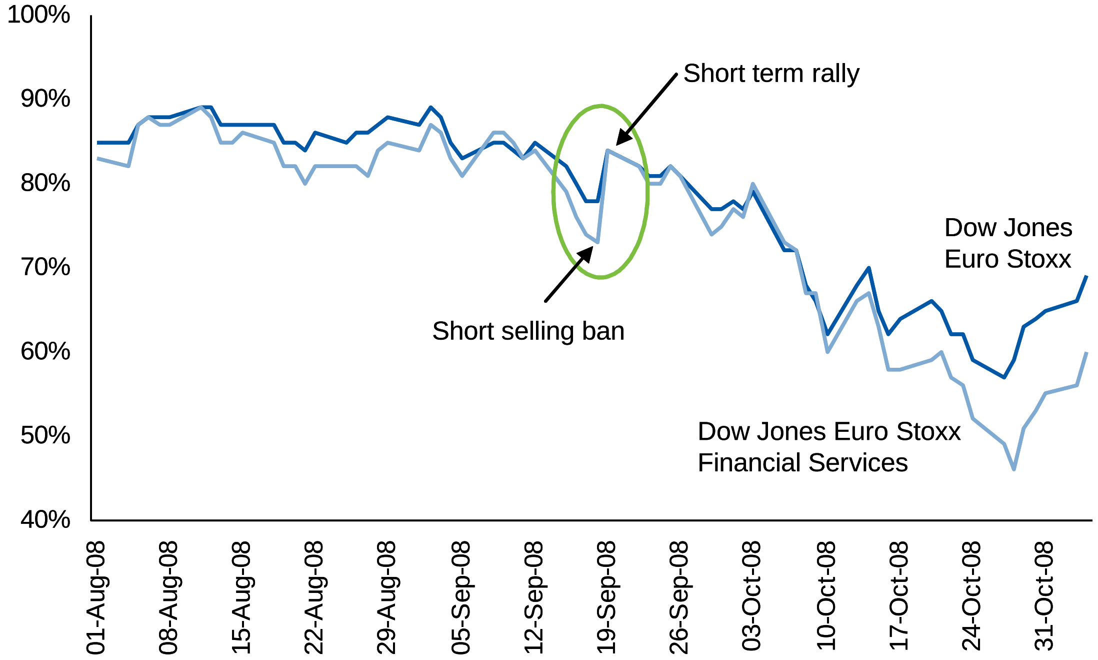


Figure 5: Evolution of Financial Services Stock vs. Stoxx 50 Index



Based on this assessment, we are not convinced that the short selling ban was a suitable measure in the first place. In fact, we believe that the ban actually sent an ambiguous message to the markets. Regulators have implicitly told the markets that the practice of short selling resulted in distortions in the price discovery process, and more broadly, that it allowed some market participants to manipulate prices. However, we believe that, on the contrary, the price discovery process did function, and that the short selling ban has actually distorted the price discovery process. The ban has ultimately undermined confidence in the markets.

Finally, available evidence shows that the introduction of the short selling ban drove many investors away from the markets. Many mainstream investment strategies were suddenly no longer viable and investors had to sell or reduce their exposure. The short selling ban contributed to the general shrinkage of the market, which disproportionately affected financial institutions.

In particular, without short selling, the concept of absolute return is constrained and many hedge funds cannot operate. Because hedge funds are significant investors in financial institutions, the short selling ban significantly increased the general pressure to sell the stock of financial institutions. It may actually have been counterproductive.

2.3.4. How to deal with disorderly markets

(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?

Clearly, no regulator will ever exclude any particular measure (including a short selling ban) from its arsenal when confronting the risk of a major financial meltdown. Although we have no convincing evidence thus far of disorderly markets or of short selling being the core problem, we would be pleased to engage with regulators to discuss a framework of measures to restore order to dislocated markets by:

a) Developing a rigorous process for identifying disorderly markets
b) Discussing the spectrum of tools/mitigants regulators can employ to counter disorderly markets

As part of this, restrictions on short selling might be only one of the available tools. We believe that in many instances short selling will not be the cause of disorderly markets. However, we would also be happy to discuss tools and approaches in the context of disorderly markets with respect to short selling, including for example a staggered ("waterfall") approach applicable to short selling (as illustrated in Table 2).

Table 2: Illustrative overview of "waterfall" approach to counteract disorderly markets

	Potential measures
Stage 1	• Short selling restrictions during rights issuance periods of banks (eg lowered disclosure threshold)
Stage 2	• Banning of uncovered/naked shorting
Stage 3	• Enhanced disclosures (aggregate disclosure to regulators)
Stage 4	• Uptick rule
Stage 5	• Banning of covered shorting
Stage 6	• Suspending stocks from trading /closing a market

This waterfall approach would equip regulators with a more finely tuned arsenal of tools with respect to short selling and to correcting disorderly markets while avoiding the most draconian measures, such as banning covered shorting or suspending stocks/markets. This approach, we believe, will reduce the overall damage to the markets. It should be noted that some key countries (notably Germany) have only imposed bans on naked short selling in the recent crisis. This is indeed significantly less interference with the market process (given that uncovered shorting is uncommon in Europe) than a complete ban (as enacted in the UK).

Should there be a general disclosure of short positions

Discussion has recently centred around whether there should be a general disclosure regime applicable to short positions, particularly since several regulators have recently stepped up disclosure requirements in this area.

In the UK for example, the FSA introduced emergency measures in June 2008 requiring the disclosure of short positions representing 0.25% or more of the issued capital of a UK-listed company which engage in rights issues. Additional measures were introduced relating to financial companies in September 2008, prohibiting the active creation of net short positions in publicly quoted financial companies as well as disclosure of all net short positions in excess of 0.25% of the ordinary share capital.

The HFSB believes that there are two main motivations behind additional disclosures of short positions, 1. financial stability, and 2. market integrity/efficiency. The following table assesses to whom disclosure is relevant, what type of information should be disclosed, and what potential concerns could arise.

Assessment of short selling disclosure regimes

Factor	Reasoning	Relevance to whom	Type of information	Potential concerns	Application
Financial stability	Enabling regulators to spot and counteract risk of disorderly markets and financial instability	Regulators	Aggregate short position (eg to assess it in relation to trading volume)	• Cost to collect/ aggregate data • Leakage risk of individual position	Only during times of distress
Market integrity/ efficiency	Allowing better price discovery Allowing transparency for control purposes	All market participants Regulators	Individual (manager level) short positions	• Discouraging information acquisition	Always

There is one important distinction to highlight regarding the disclosure regimes illustrated above. While for financial stability purposes, the <u>aggregate</u> level of shorts is relevant to regulators, it is the <u>individual</u> manager level disclosure that is relevant in the market efficiency/integrity context to all market participants and regulators . In the latter context, the question arises what should be the adequate disclosure thresholds for individual short positions. The HFSB believes that a symmetric approach is appropriate, mirroring the disclosures required in the context of long positions for the following reasons:

- The market impact of long and short positions is similar;
- Underpriced stocks are equally damaging as overpriced stocks from a market efficiency perspective;
- The risk of market manipulation is equally damaging whether it takes place in the form of long or short positions.

Currently, the long position disclosure regimes vary by country. In the UK, the Disclosure and Transparency Rules require disclosure of the combined long position of shares and CFDs if the 3% threshold is exceeded and for each percentage point thereafter (UK issuers).

Beyond establishing a symmetric approach for short disclosures, HFSB would welcome further European/global harmonisation of disclosure mechanisms.

2.4. Management of micro prudential risks

(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?

In the area of risk management, the relevant entity to focus on is the hedge fund manager (which is in charge of managing the assets/risks).

Hedge fund managers in the UK are subject to FSA regulation (and ultimately EU regulation), similar to any other asset manager (eg retail asset managers, etc.). An important element of this regime is the registration process for managers, which focuses on ensuring the fitness and properness of the manager. Once authorised, a hedge fund manager is required to follow FSA's rules and principles, which include requirements on management and control, ie risk management systems. In addition, hedge fund managers are required to file regular reports to the FSA, and FSA conducts visits at hedge fund managers. In addition, FSA maintains direct relationships with the largest hedge fund managers in the UK.

In addition, the Hedge Fund Standards Board has set out detailed Standards covering all relevant areas of risk management, including portfolio risk management, liquidity risk management, and operational and outsourcing risk.

The HFSB believes that the regulation and Standards currently in place are sufficient, and that there is no requirement for additional regulation in the European context (ie UK).

In the area of administration, the HFSB has dedicated Standards on the segregation of functions in valuation, and believes that independent third party valuation arrangements are the most satisfactory way to mitigate conflicts of interest in this area. In addition, the HFSB is currently looking into strengthening its requirements on independent administration. The HFSB does not see a need for more granular governmental regulation in this area.

2.5. Transparency towards investors and investor protection

(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?

Most hedge funds rely on sophisticated investors (UHNW, institutional investors), with an increasing share of institutional monies. These are knowledgeable and sophisticated – or they have the resources to hire knowledgeable and sophisticated advisors – and therefore do not need the protection of regulators in the way retail investors do. Clearly, hedge funds have to abide by the general requirements of integrity and respect for market rules such as those underlying the FSA principles.

The Hedge Fund Standards are an important tool to enhance transparency. Disclosure and transparency are at the heart of the approach taken by the HFSB regime, and managers who sign up to the Standards commit themselves to a broad spectrum of ex ante and ongoing disclosure requirements in areas such as investment policy, risk taking, operational arrangements, fund governance and commercial terms. Beyond disclosure, the Standards set a benchmark for operational practices that investors can compare managers against. The HFSB believes that this market-based approach is much better suited to improve the industry, and ultimately let sophisticated investors decide with their allocation of funds which managers come up to their requirements.

Therefore, the HFSB does not see a need for additional regulatory efforts.

(11) In 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?

The amount of investor protection depends on the nature and sophistication of investors. Subject to appropriate controls, the HFSB has no objection to allow retail access to hedge fund exposures.

It is worthwhile mentioning that retail investors can already invest in listed hedge funds, which then fall under the same regulation and requirements as listed companies.

Appendix A:

Top 10 FTSE 100 stocks by % shares on loan (8 September 2008)[13]

*"no banks among top 10 stocks by % share on loan"**

Instrument Name	% of share on loan
SAINSBURY	34.3
AMEC ORD	25.7
LIBERTY INT	25.3
LON ST EX	22.7
VEDANTA	21.2
THOMAS COOK GRP	19.7
WOLSELEY	19.4
BA	17.7
KINGFISHER	17.4
INTER HTL	15.7

For comparison purposes: Most borrowed stocks in the European banking sector[6]

*"no UK banks among the most borrowed European banking stocks"**

Instrument Name	Mkt Cap (US$bn)	Days of Impact *	Estimated Market Short as a % of Mkt Cap
BCO POPULAR	12.4	14	10.0%
SWEDBANK	8.7	7	8.7%
ERSTE BANK	18.0	21	7.9%
HYPO REAL ESTATE	5.0	6	7.0%
DEXIA	16.7	15	6.8%
DEUTSCHE BANK	43.7	5	6.5%
EFG INTERNATIONAL	4.6	25	3.9%
BANCO SANTANDER	100.0	3	3.2%
BBVA	62.7	3	3.0%
SNS REAAL GROEP	4.0	7	2.7%
SOC GEN	53.9	4	2.7%
PARTNERS GROUP	3.6	22	2.6%
FORTIS	31.4	3	2.1%
INTESA SANPAOLO	65.9	3	1.6%
NORDEA BANK	32.8	5	1.5%
KBC GROEP	31.3	6	1.4%
JULIUS BAER HLDG	12.5	2	1.4%
UNICREDIT	69.8	1	1.1%

Source: UBS estimates
Note: * Days of Impact is the estimated number of days of average traded volumes to unwind the position

* Share on loan/borrowed stock does not only include "classical" short selling, but also includes stocks borrowed to facilitate settlement of trades and hedging.

[13] Source: UBS Investment Research, European Equity Strategy, 12 September 2008