European Commission  
DG Internal Market  
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**RESPONSE TO THE CONSULTATION PAPER ON HEDGE FUNDS**

State Street Corporation, headquartered in Boston, U.S.A., specializes in providing institutional investors with investment servicing, investment management and investment research and trading. With $12.04 trillion in assets under custody and $1.44 trillion in assets under management, State Street operates in 27 countries and more than 100 markets worldwide. Our European-based workforce of over 6,200 employees provides institutional investors with local support and service from our offices in Austria, Belgium, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Poland, Switzerland and the United Kingdom.

Dear Sirs, dear Madams

State Street Corporation would like to thank the European Commission for the opportunity to comment on the consultation paper on hedge funds.

We would be happy to discuss with you, in further detail, any comments you may have. Please do not hesitate to contact Gabriele Holstein at 0041 44 560 5101.

Sincerely,

Stefan Gavell  
Executive Vice President  
Regulatory and Industry Affairs

Dr. Gabriele Holstein  
Director of European Regulatory and Industry Affairs
State Street Corporation’s Response to the  
EC Consultation Paper on Hedge Funds  
(The “Paper”)

INTRODUCTION

This memorandum contains State Street’s response to DG Internal Market’s working document on hedge funds. We appreciate the opportunity to share our views and comments on this important matter.

According to the Commission, the consultation will play an important role in identifying and shaping a European response to vulnerabilities emanating from the hedge fund sector, with responses to and conclusions from this consultation serving as the basis for a regulatory initiative which the Commission will present to the European Parliament by spring this year.

In State Street’s view, any attempt for a legislative initiative targeting hedge funds as a distinct group of actors would be frustrated by the absence of a clear-cut definition of the hedge fund industry and would lead to unintended consequences. In the context of the recent financial markets turmoil, we would instead advocate a thoughtful regulatory approach to asset management activities and techniques, especially of strategies which are highly complex and make use of excessive leverage. To address the current lack of transparency and to increase confidence in the sector, we would further advocate increasing hedge fund disclosure requirements to regulators.

Given the international dimension of the asset management industry, a purely European regulatory response would not be effective in our view. The Commission should work with other regulatory authorities and international standard setting bodies to create a consistent global framework.

We are, however, supportive of a Europe-specific assessment of the hedge fund industry. The main reason for this is that there are considerable differences between
the European and the US hedge fund landscape in regards to how hedge funds are set up, managed, administered and distributed which need to be well understood prior to considering any regulatory measures.

In regards to systemic risks, we do not believe that recent experience requires a reassessment of the systemic relevance of hedge funds as a distinct class. The systemic problems experienced by financial markets over the last several months were triggered by factors such as illiquidity, leverage and opaque financial instruments which are common to the market as a whole.

State Street’s detailed responses to the specific questions posed in the Paper follow below.

**CHAPTER 1 - SCOPING THE ISSUES**

(Q1) 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?

A focus on the delivery of absolute returns, the relatively high and systematic use of leverage, and an investor base traditionally confined to institutional or other sophisticated investors, are features which generally characterize hedge funds, regardless of where they are domiciled or managed from. An additional generic feature is the charging structure, consisting of both a management and a performance fee. Furthermore, hedge funds typically denote funds which are not product-regulated, *i.e.* they have maximum flexibility in their trading strategies and the type of financial assets they invest in.

Given the potential impact of leverage on financial markets and the lack of broad-based transparency, the hedge fund industry may be worthy of targeted assessment.
We believe, however, that any attempt for a legislative initiative targeting hedge funds actors specifically would be frustrated by the absence of a clear-cut definition of the hedge fund industry and would lead to unintended consequences. From an investment strategy perspective, the distinction between hedge funds and other actors is increasingly difficult to make, with a growing number of funds employing investment strategies which originated in the hedge fund domain. The deployment of such strategies within an investment fund is no longer a distinct feature of hedge funds. A regulatory assessment of strategies applied by hedge funds is therefore no more or less justified than an assessment of hedge-fund like strategies applied by other actors.

In the context of the recent financial markets turmoil, we therefore advocate a thoughtful regulatory approach to asset management activities and techniques, especially of strategies which are highly complex and make use of excessive leverage.

Furthermore, it is important to note that there are significant differences not only between the US and European hedge fund industry, but also within the European hedge fund sector, where structures differ from country to country, as we explain further in our response to Q2. Any potential regulatory initiative would therefore need to consider the heterogeneity of the industry.

(Q2) Given the international dimension of hedge fund activity, will a purely European response be effective?

We do not support the notion of Europe “going it alone” to introduce hedge fund regulation, as it could damage the quest for convergence of global financial markets. Regulators also need to consider that an isolated European response bears the risk of regulatory arbitrage if such regulation is seen as onerous or expensive. The Commission should therefore work with other regulatory authorities and international standard setting bodies such as IOSCO to create a consistent global framework.

Notwithstanding the above, we believe that a Europe-specific assessment of the hedge fund industry is a sensible approach. The main reason for this is, as mentioned above, that there are considerable differences between the European and the US hedge fund landscape in regards to how hedge funds are set up, managed, administered and
distributed which need to be well understood prior to introducing any regulatory measures. It is relevant to note in this regard that the European hedge fund industry is already regulated to a great extent. While European fund vehicles are frequently established in off-shore jurisdictions, the funds’ managers themselves for the most part are located on-shore and concentrated in locations such as London. As a result, a UK-based asset manager managing an “offshore” hedge fund is already regulated and supervised by the FSA. In addition, hedge fund trading in Europe falls under existing EU rules such as the Market Abuse Directive and is therefore already within the EU’s regulatory reach.

Hedge funds which operate outside EU or national regulation are likely to remain unaffected by any new EU regulation. We believe this to be an important aspect in the overall discussion of potential regulation as the so called “unregulated European hedge funds” the Commission is aiming to address do not really exist.

CHAPTER 2 - SYSTEMIC RISKS

(Q3) Does recent experience require a reassessment of the systemic relevance of hedge funds?

We do not believe that recent experience requires a reassessment of the systemic relevance of hedge funds as a distinct class. The systemic problems experienced by financial markets over the last several months were triggered by factors such as illiquidity, leverage and opaque financial instruments which are common to the market as a whole. We emphasize in this regard the particular danger of excessive leverage on systemic risk. This problem is, however, not distinct to the hedge fund industry, but rather to a broad group of actors within the financial industry. It is important to note in this context that hedge funds employ a wide range of strategies and not all make an inappropriate use of leverage.
(Q4) 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?

We believe the indirect regulation of hedge fund leverage to be the most effective way to insulate the banking system. In response to the crisis, prime brokers have considerably strengthened their due diligence in regards to which hedge funds they are prepared to lend to. Furthermore, many prime brokers have considerably increased their margin requirements, thereby triggering a substantial increase in the cost of leverage and hence a reduction of lending activities. This demonstrates the effectiveness of the existing indirect regulatory approach.

Furthermore, the regular review of prime broker lending may be a more effective way for regulators to monitor the borrowing levels of hedge funds than the direct collection of information, since the global prime brokerage industry is relatively well-concentrated.

(Q5) 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?

Increasing hedge fund disclosure requirements to regulators is a sensible approach as it would address the current lack of transparency and is likely to increase confidence in the sector. Data to be disclosed on a confidential basis should include: assets under management, portfolio holdings and generic information on market, credit, liquidity and operational risk. We note in this regard the importance of analyzing the data on an aggregate rather than an insolated basis. This will require regulators to build a better understanding of the different types of risks, as well as models to measure and monitor risk.

The data itself should be strictly limited for regulators’ use only and should not be released to the general public in disaggregated form.
Furthermore, we note that central banks already have a comprehensive set of data available through the data gathering exercise coordinated by the ECB\(^1\). To avoid duplication and additional costs for the industry, the ECB could provide already existing data to build a better understanding of the industry.

In regards to monitoring the contribution of hedge funds to asset price movements, we note that transaction reporting requirements of MiFID already require that detailed information be supplied to regulators on a trade by trade basis. The introduction of the Transaction Reporting Exchange Mechanism (TREM) should therefore provide regulators with all of the information they require.

CHAPTER 3 - MARKET EFFICIENCY AND INTEGRITY

(Q6) 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?

Yes, the recent reduction in hedge fund trading has affected the overall efficiency of financial markets. Trading volumes, especially in OTC markets, have strongly declined, with worse price formation manifesting itself in larger spreads and decreased liquidity. We would, however, reiterate the view that hedge funds are not the focal point of the current financial crisis. As per our earlier comments, the existing crisis largely emanated from regulated areas of the market, with the US subprime mortgage sector at its core.

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(Q7) Are there situations where short selling can lead to distorted price signals and where restrictions on short-selling might be warranted?

Instances where short selling leads to distorted price signals cannot be ruled out, especially in illiquid markets. We believe, however, that an outright ban on short selling is not warranted. There is sufficient evidence on the detrimental impact of short-selling restrictions on overall market efficiency. We believe that short sellers are an integral component of financial markets, playing a key role in both price formation and the provision of liquidity. Eliminating this function is likely to have considerable and unwelcome consequences on trading activities. However, we strongly support measures aiming to prevent abusive short selling.

(Q8) 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?

We view short selling as problematic only in instances of market illiquidity and where there are lax controls on leverage. We also note problems which can develop in markets with a large degree of naked short selling.

In our view, the most sensible approach to these concerns is to limit the risk posed by the widespread use of leverage and to ban or restrict abusive short selling. This should, however, be considered to the financial industry as a whole, not simply to hedge funds. Please refer in this regard to our response to Q7 on the detrimental impact of broader short-selling restrictions on market efficiency.

2 The LSE, for example, highlighted in its recent study on the liquidity effect of short-selling restrictions that (i) the spread in banned stocks increased by 140% compared to a 56% rise in control stocks, (ii) trades and volume fell by approximately 10% in banned stocks, whilst the number of trades and share volume increased by 50% in control stocks and (iii) turnover in banned stocks fell by 21% compared to a 42% increase in control stocks. Furthermore, banned stocks were reported to have lower liquidity compared to the control sample. Source: Clifton, Matthew and Snape, Mark (2008): The Effect of Short-selling Restrictions on Liquidity: Evidence from the London Stock Exchange.
Generally speaking, we view the tightening of market abuse rules to be a more effective regulatory response than the outright banning or substantial restriction of short selling. We are unsure, however, to what degree it may be possible to tighten existing national or EU level rules such as the Market Abuse Directive.

CHAPTER 4 - MANAGEMENT OF MICRO-PRUDENTIAL RISKS

(Q9) 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 light of recent events, risk management within hedge funds has become a key issue. Over the past 18 months, hedge funds have become more focused on diversifying risk away from a single prime broker model, starting to use traditional custody banks, with an increase in third-party custody arrangements that allows collateral to be held away from the counterparties. Furthermore, recent market events have prompted hedge fund managers to re-examine their various risk monitoring techniques to ensure that they include different worst-case scenarios in their models and to fully understand how their portfolios react. Finally, a trend toward independent administrators and independent valuation of the portfolios is also gaining momentum.

We believe that these industry-led developments should be encouraged to increase the transparency of the hedge fund industry. As part of this process, hedge funds’ internal governance and management should be “benchmarked” against principles set by a industry code of practice. We believe the most important pillars of good governance are:

- Independent pricing/avoidance of counterparty pricing,

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3 Over the last years, a number of organizations (IOSCO, AIMA, HFSB, MFA) have developed best practice guidelines for hedge funds which should be the basis of the code (see www.hedgefundmatrix.com for an overview of the principles). For Europe, AIMA’s Guide to Sound Practices for European Hedge Fund Managers is an excellent basis.
- Requirement to report a standardized price/performance measure,
- Segregation of the safekeeping function,
- Independent administrator, and
- Requirement that only regulated entities may provide key services such as administration, safekeeping and prime brokerage.

Since many hedge funds are still self-administered, the last three points strike us as particularly important. The segregation of assets and the introduction of a mandatory custodian/depository function would considerably enhance transparency and investor protection. Adherence to a code of practice should be assessed by outside auditors. To ensure auditor independence, they should be employed by the association(s) in charge of elaborating the code.

A particular area where a regulatory initiative could complement industry codes would be in regards to dealing with the re-hypothecation (pledging) of assets of hedge funds at the prime broker level, which has caused difficulties in the wake of the collapse of Lehman Brothers. Firstly, the Commission could consider limiting the extent to which assets may be re-hypothecated, as such a restriction is likely to make leverage more difficult to access. Secondly, reporting and transparency requirements in respect of re-hypothecated assets could be introduced, so that it is clear to what extent this practice is being engaged in. Lastly, the Commission should consider introducing more prescriptive requirements about assets which are not re-hypothecated (excess assets), including requirements as to how and where they are held. Particularly helpful in this regard would be a requirement to segregate the assets and to place the assets with a non affiliated third-party entity.
CHAPTER 5 - TRANSPARENCY TOWARDS INVESTORS AND INVESTOR PROTECTION

(Q10) 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?

According to the Commission, there are concerns that hedge funds do not always provide sufficient information on a pre-contractual and ongoing basis to allow investors to assess the risks of their investments. We believe that the risks associated with the use of leverage, the re-hypothecation of assets and counterparty risk need to be properly documented in accordance with best-practice principles in a code of conduct (see our response to Q9) so that investors can make an informed judgment of the risks pertaining to the hedge fund. The fund documentation should contain all material information to allow prospective fund investors to analyze whether the fund will make a suitable investment. In reports to investors issued in regular intervals, the fund manager should communicate any changes or re-confirm that the initial documentation remains accurate. Where there is a failure to disclose information material to an investment decision, liability should arise.

A requirement could also be introduced whereby the investor must accept in writing an acknowledgement of risks involved in investing in the fund prior to any initial investment.

(Q11) 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?

State Street only services institutional clients. We therefore choose not to offer our insight on this particular matter apart from the general statement that we find the definition of sophisticated investors to be a useful concept.