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AK Position Paper

Consultation paper on hedge funds

About us

The Federal Chamber of Labour is by law representing the interests of about 3.2 million employees and consumers in Austria. It acts for the interests of its members in fields of social-, educational-, economical-, and consumer issues both on the national and on the EU-level in Brussels. Furthermore the Austrian Federal Chamber of Labour is a part of the Austrian social partnership.

The AK EUROPA office in Brussels was established in 1991 to bring forward the interests of all its members directly vis-à-vis the European Institutions.

Organisation and Tasks of the Austrian Federal Chamber of Labour

The Austrian Federal Chamber of Labour is the umbrella organisation of the nine regional Chambers of Labour in Austria, which have together the statutory mandate to represent the interests of their members.

The Chambers of Labour provide their members a broad range of services, including for instance advice on matters of labour law, consumer rights, social insurance and educational matters.

More than three quarters of the 2 million member-consultations carried out each year concern labour-, social insurance- and insolvency law. Furthermore the Austrian Federal Chamber of Labour makes use of its vested right to state its opinion in the legislation process of the European Union and in Austria in order to shape the interests of the employees and consumers towards the legislator.

All Austrian employees are subject to compulsory membership. The member fee is determined by law and is amounting to 0.5% of the members' gross wages or salaries (up to the social security payroll tax cap maximum). 560.000 - amongst others unemployed, persons on maternity (paternity) leave, community- and military service - of the 3.2 million members are exempt from subscription payment, but are entitled to all services provided by the Austrian Federal Chambers of Labor.

Herbert Tumpel
President

Werner Muhm
Director

The AK position in detail

The AK makes the following statement regarding the consultation paper of the EU Commission on hedge funds:

(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 AK considers the inclusion of significant investors as banks, insurance companies and pension funds into the regulation approach as reasonable.

Apart from the main actors, who have been named in the text, the inclusion of significant investors into the regulation approach seems to be sensible. On the one hand, these concern banks and insurance companies, where the exposure in case of hedge funds could have an impact on the balance sheet as well as those institutional investors, who are not end users of these instruments, such as pension funds, on the other. In the case of pension funds, the risk, in accordance with the risk allocation structure, will be distributed between pension fund operators, employers and employees. If employers in a performance-oriented system are subject to reserve liability, any problems associated with certain assets such as hedge funds or private equity funds, might also have an impact on companies' balance sheets and their equity capital; moreover, these channels may also have a contagious effect. In case of contribution-oriented systems, where the risk almost completely or to a large degree lies with members who have accrued rights and beneficiaries, failed investments in hedge funds and private equity funds could result in substantial loss of income, which would in particular lead to a greater risk of poverty among older people. Here, quantitative limits should be reintroduced, because experience has shown that the complexity of the internal models was even too great for the managers of leading institutional investors. In the end, quantitative and simpler regulations are more easily comprehensible for end users, internal control systems and supervisors and can therefore increase transparency and efficiency.

Evidence therefore suggests that in accordance with the complexity and intricacy of the problems associated with unregulated instruments and market participants, these deficits should be tackled at all relevant levels, including the hedge funds managers named in the text, the funds themselves, the administrator (custodian bank), but also the important institutional investors and the instruments, in order to isolate the risks as good as possible making them therefore better controllable.

The Commission paper in particular aims at analysing hedge funds with respect to their impact on the stability of the financial markets. This is clearly not sufficiently effective. With their model of leverage financing and the demand for two-digit returns on investments, hedge funds have a massive impact on the real economy, whose growth rates are regularly below 5 %. The analysis, which must also include the impact of the business model of the hedge funds on the real economy, must therefore be widely accessible.

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

The AK points out that the global dimension of the financial markets requires a close international cooperation and joint standards. The guarantee of this would obviously refer to the EU.

One has to agree with the declarations of the G20 financial summit, that it should be the fundamental objective that no actor in the financial markets, no finance product and no world region would remain unregulated or unsupervised. The guarantee of this should above all be a national matter; in the case of the EU this would obviously refer to the Community level.

Due to the fact, however, that in the meantime financial markets have become global, this requires close cooperation and joint standards. Market discipline, innovation and dynamics should be promoted and negative effects for other countries should be avoided. Companies and investors should not be able to benefit from regulation differences between states („regulation arbitrage").

Taking this into consideration, instruments from countries, which evade these principles, might indeed become subject to restrictions or special assessment for taxation. Stricter balance sheet regulations for off balance sheet transactions by banks, which significantly contribute to financing hedge funds, can in addition increase the effectiveness of the regulation of hedge funds and comparable products at Community level.

Apart from that, intelligent regulations can also contribute to confidence building and represent a quality feature.

The extent of the crisis, not least triggered by supposed financial innovations, high leverage and wrong incentives in remuneration and evaluation systems clearly shows that reregulation is urgently needed to correct undesirable developments and to restore trust.

The current crisis has in particular shown that the system of self-regulation has failed.

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

It lies in the nature of models, which are subject to hedge funds strategies that they are able to illustrate the specific risk based on historical data relatively well. Over the past years, these models were even more refined and used more than ever before. As the models, however, are neither able to illustrate systemic risks nor processes or volatilities, which historically have

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By dividing the risks, they were initially distributed more widespread, so that market participants arrived at the conviction that by applying technical risk management, they would also come to grips with risks, which could not be optimally evaluated in the markets. Hereby, hedge funds were playing a significant role. In actual fact, however, these financial innovations contributed to the increase of the systemic risk. In the confidence that risks were manageable, risk premiums were arbitraged away, as a result of which prices lost their information function.

Such risk increase, for example, also becomes evident through the development in the raw material markets up to summer 2008. Here, index speculations - i.e. using financial instruments for raw materials as a new asset class in the funds - resulted in a significant increase of volume, prices and volatility.[1] This had a direct impact on companies and households and, because of the simultaneous occurrence of inflation and economic downturn, also presented a dilemma to economic policy.

Due to the fact that they were the driving forces behind these financial innovations, were able to pool large sums and increased the risk with high leverages, hedge funds have intensified these developments. In particular the liquidity risk of very complex products was neglected in the bull market. If in times of crises, capital is taken away from hedge funds, the latter find themselves in a double squeeze, which gives them a more risk-increasing effect. They are forced to sell assets, for many of which a functional market is no longer available in times of crisis, forcing them to sell above all those assets, for which a market still exists. As a result, these markets too may experience a decline in prices and/or liquidity problems. Consequently, the liquidity risk of some funds can develop into a system risk.

(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?

In the eighth quarter since the outbreak of the crisis and following massive support measures in form of recapitalisation measures and guarantees by the public sector, banks are still to a large extent using the facilities of the central banks as a substitute for the interbank market. This is an indication that the uncertainty about the liquidity risk and the counterpart risk is still so significant that the interbank market has not yet recovered normality. Especially off-balance sheet positions as well as positions towards

1 Compare: Testimony of Michael W. Masters, Managing Member / Portfolio Manager, Masters Capital Management, LLC before the Committee on Homeland Security and Governmental Affairs United States Senate May 20, 2008. http://hsgac.senate.gov/public/_files/052008Masters.pdf

The AK underlines that an indirect supervision of hedge funds activities is not sufficient and proposes to set unified EU-wide regulations with respect to registration, responsibilities, borrowing and capital requirements.

hedge funds are playing a part in contributing to this situation.

However, further regulating measures are not only required at hedge fund or prime broker level, but also for the banking sector. Off-balance sheet transactions and in particular transactions based on instruments from mainly unregulated offshore centres have to be included in the deposit regulations.

Just an indirect supervision of hedge funds activities is not sufficient. Hedge funds have to be regulated and controlled directly, both at portfolio management level as well as at the level of the management companies, which are managing these funds (mainly limited partnerships, whose internal organisational structure is not subject to any corporate governance standards). The target has to be a unified EU-wide set of regulations with respect to registration, responsibilities, clear rules concerning borrowing and capital requirements.

(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?

Due to the lack of transparency, supervisory authorities sometimes do not even know the levers, making an assessment of the real risk significantly more difficult. The demand for transparency - for both investors and supervisory authorities - is therefore a minimum requirement. As a result, all instruments and institutes have to adopt a "see through" approach. That means all transactions have to be disclosed to the supervisory authority. But also the concrete configurations of financial derivatives have to be documented in preferably standardised form, as the supervisory authorities, without knowing the (details of the) transactions, can only say little about what impact hedge funds could have on the price formation process.

(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?

The current situation on the financial markets is characterized by a dramatic loss of trust, a high information asymmetry and liquidity at a large number of markets, where more probably a surplus liquidity existed prior to the breakout of the crisis. This surplus liquidity for example was expressed by the fact that some markets were characterized by at times irrationally low risk premiums. Following the standstill of some markets and given the fact that even in the eighth quarter following the breakout of the crisis some market participants do neither know the actual write-off requirements nor the actual liquidity requirements, the current price formation must still be interpreted as maladjusted. Although hedge funds are not the only market participants to fall into this category, due to their lack of transparency, however, the problem here seems to be particularly significant as they affected both actively as well as passively.

There is at present no indication that the current liquidity difficulties are result of the restrictions of short selling.

The investigations of the European Commission should also analyse the effects hedge fund activities have on specific markets, such as the raw material or the food market.

The investigations by the Commission should go beyond the financial market. It would be absolutely vital to analyse the effects hedge fund activities have on specific markets, such as the raw material market or the food market (also compare the comments to question 3).

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

Basically, the speculation by means of short selling belongs to those techniques, which can stem irrational exaggerations and turn them into something positive, thereby - if one follows the textbook - being able to contribute to rational price formation.

The pooling of large sums, combined with trading techniques concerning "absolute return" strategies via IKT supported short selling, can increase an existing downwards trend, thereby pushing finding a stable base for the prices further away. That means that in a bull market short selling strategies can lead to irrationally low prices thereby sending out wrong price signals. If such techniques occur in combination with the targeted spreading of rumours, the market manipulation, due to the high levers, is confronted with hardly any resistance.

What is important is that the option or future positions are subject to the same notification requirements as the relevant underlying positions. In cases where underlying securities transactions are subject to general or specific restrictions, these must also apply to the relevant derivative positions.

The suspension of trading concerning such financial vehicles/instruments is, however, in case of the high information uncertainty in the financial markets, as it is currently the case, sensible.

(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?

This question is closely linked with question 7. Short selling techniques can - by means of targeted spreading of rumours with relatively small effort due to the high levers - be used for manipulating the market. As hedge funds can pool large sums from investors and are able, due to the levers, to multiply their market power far beyond the available volume, they should be subjected to direct measures against these practices. At the same time it would be advisable to also review the general market abuse regulations.

As hedge funds are currently subject to less stringent regulatory obligations than for example banks or insurance companies, it is a necessary condition to integrate them into these supervisory mechanisms in order to be able to recognize and to combat market abuse.

In addition to this approach, the use of transaction taxes depending on volatility measures could have a stabilising effect.

Risk management processes, valuation rules and transparency regulations should therefore be regulated by statutory provisions, which orient themselves on other financial institutions.

(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?

Voluntary codes of conduct do not guarantee sufficient certainties regarding their comprehensive observance, and can, in particular in individual cases, be easily broken. As shown in practice (e.g. Corporate Governance Codex at the Vienna Stock Exchange), voluntary codes of conduct are often not adhered to and are therefore "toothless".

Apart from that there is evidence that public investment strategies and risk management processes are not always consistent with actual strategies, and that, in particular if the funds come under stress, strategy changes might be taking place.[2] This could lead to situations, where investors end up holding different risk positions than originally intended. Apart from other problems, which are associated with a lack of transparency, this might result in significant distortions on the side of the investors. In cases where institutional investors are not the final beneficiaries and the risk is fully transferred to end consumers, as is the case with contribution-oriented pension fund models, this also might directly lead to a loss of income and increased poverty among older people.

Risk management processes, valuation rules and transparency regulations should therefore be regulated by statutory provisions, which orient themselves on other financial institutions, such as banks and insurance companies. Remuneration and incentive systems for managers should be more long-term oriented and not lead to excessive risk tendency.

As to the minimum capital resources of hedge funds: hedge funds often operate with large amounts of outside capital when financing company takeovers. The target company is then increasingly required to cooper-

2 Baghai-Wadji, El-Berry, Klocker, Schwaiger: The Consistency of Self-Declared Hedge Fund Styles — A Return-Based Analysis with Self-Organizing Maps, in: Österreichische Nationalbank: Financial Market Stability Report 9 / 2005; http://www.oenb.at/en/img/fsr_09_special_01_tcm16-29255.pdf

ate in the repayment of these loans through forced dividend distributions (target company has to "buy" itself). Here it would appear target-aimed to demand legal regulations aimed at restricting financing through loans as well as special distributions at the expense of the financial power of the target company.

In addition to internal measures, regulating measures, which concern the target companies of hedge funds and private equity funds, would be sensible.

In addition to internal measures, regulating measures, which concern the target companies of hedge funds and private equity funds, would, however, be sensible:

Measures at the level of the target company of hedge funds:

- Restriction of share acquisitions (e.g. maximal 10 % of the target company)
- Strengthening of the target company against undesired takeovers: In our opinion, one could still consider the Golden Shares, which were rejected by the Commission, the suspension of voting rights, multiple voting rights in case of long-term investments. The Commission determined in a Communication that free capital movements does (of course) not enjoy absolute, sacrosanct protection, but that it can be curtailed in certain cases. From our point of view, these include also dangers to national security or the areas concerning services for the public.

Measures at the level of target companies of private equity funds:

- Review of the Transfer of undertakings directive, taking particular account of LBOs.
- Measures to protect employees: greater say - concretization of the right to say of employees within the scope of the Transfer of undertakings directive. Another possibility would be to introduce veto rights in case of intransparent, obscure takeover attempts.
- It would also be conceivable to determine the possibility of special audits in case of a control change through hedge funds (for example through a minority in the administrative centre [HV] but also in the board) - in particular in cases where a damage to the company is anticipated. Should this audit establish that the fund is operating "against" the company, one could also consider restricting the voting rights (within the realms of possibility).
- Restriction of the transfer of debts of the target company to prevent the depletion of equity capital.

(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?

Due to the fact that hedge funds are to a large extent unregulated market participants, the actual flow of information is strongly dependent on the relation of fund and investors. There are, however, strong indications that information provided by hedge funds themselves deviate from the investment styles and thereby from the actual risk of the actual investment styles.

Following the fact that even major investors with considerable know-how were significantly affected by the risks incurred, an intensified spread of hedge funds has to be critically assessed.

Voluntary codes of conducts seem therefore not very well suited to regulate the information flow which is essential for making an investment decision. Statutory provisions and regular reports concerning owner structure, assessment style, assessment structure and risk-adjusted performance or about the congruence of own information and actual style to auditors, supervision and investing public thereby appear to be advisable.

Institutional investors too, such as funds and pension funds, which themselves hold hedge fund shares, must be given the opportunity to examine information, which concerns them indirectly.

This is even more important as in case of hedge fund participations there is in many cases no liquid market with transparent price formation, on the basis of which investors would be able to examine the plausibility of the valuation.

(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?

Following the fact that even major investors with considerable know-how were significantly affected by the risks incurred, an intensified spread of hedge funds has to be critically assessed. The complex nature and the high levers make this instrument to an investment class, which is not particularly recommendable for the general investment public and whose overall performance is also characterized by a particularly high survivorship bias.

High participation thresholds based on large denominations, which only make a participation from € 50,000 possible are therefore sensible because they only enable a very restricted application for small investors.

The indirect inclusion of these risks in private portfolios via pension funds should also be rejected beyond a strongly restricted extent. The long term nature of pension fund investments makes pension funds particularly vulnerable for high levers. The requirement for leveraged instruments is in case of such long term investments not directly clear. The supposedly low correlation with other asset classes as an argument for better diversification has to be revised in the light of the current crisis (for example in the case of raw material funds). In case of pension funds, any possible hedging instruments should only be used for safeguarding purposes.

Special care should be taken above all in those cases, where end users are directly or indirectly affected by risks, which are not traded at stock exchanges and which are therefore subject to a particular liquidity and valuation risk.

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