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# Introduction

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This book is published at a time of unprecedented crisis. A few words on its origins, their link to the activities of alternative investment funds and the recent surge to regulate them are deemed appropriate, by way of introduction.

The progressive deregulation of the European and US banking and financial systems, in conjunction with the galloping pace of financial globalization, have been amongst the salient characteristics of the last two decades of the history of finance. One of the most enduring legacies of the deregulation era, which was to see a flurry of promising financial innovation, has been the greater susceptibility of the European and US economies to asset and market bubbles, corporate scandals and failures and, more recently, to generalized financial sector and, in some cases, sovereign crises. As for globalization, one of its most lasting legacies has been the increasing vulnerability of national economies to financial meltdowns in the face of large, 'imported' shocks.

While globalization is, to some extent at least, something of a natural phenomenon, with technological innovation greatly facilitating the flow of capital from one corner of the world to the other, exposing market players to cross-border risks, deregulation is more a matter of choice. The policy makers' conscious decision to substitute the 'heavy hand of government' with the wisdom of the markets and the promise of financial innovation to contribute to the better pricing and spreading of risk have seen the US Congress repeal the Depression-era Glass-Steagall Act, which prevented depository (commercial) banks from competing with investment banks, European lawmakers liberalize the UCITS funds' investment policies, hedge funds thrive on both sides of the Atlantic and OTC derivatives markets grow dramatically in size and importance. The gradual dismantling of government regulation and the replacement of 'black letter' rules with reliance on market discipline were to set the scene for an extraordinary crisis that, largely due to the globalization-sponsored interdependencies amongst financial markets and their participants, nearly wiped out entire segments of the financial services industry, threatened the global financial system with a meltdown of epic proportions, cost taxpayers and the future generations dearly and, since late 2009, driven a growing number of European Union Member States to the brink of default.

The policy of fostering financial innovation through deregulation and

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the dismantling of normative barriers thought to impede free competition and constrain consumer choice, have both proved incapable of shielding national economies from the impact of financial crises and exposed as naïve the policy makers' reliance on market discipline as a substitute for regulation, against the dictates of common sense and the average man's knowledge of human nature and its foibles. It has also exposed the limits of economic analysis as the definitive tool for financial regulation, and cast doubts on the assumption that markets behave rationally. Three recent examples suffice to illustrate some of the deficiencies associated with reliance on market discipline and economic analysis as substitutes for external regulation; first, the massive Madoff fraud, facilitated by deficient due diligence, a lack of transparency and a combination of regulatory and supervisory inadequacies; second, the implosion of the structured finance markets, which brought to light the inability of purportedly sophisticated investors and seemingly well-regulated, by contemporary standards, market intermediaries to perform any manner of due diligence over the instruments they had created, or in which they had invested and to correctly price the risks that those carried; finally, the collapse of the housing market in the US, where what started with the best of intentions (the noble idea of promoting home ownership for the less wealthy) resulted in a market crash of unparalleled proportions due to the 'creative' but, ultimately, irresponsible financing techniques used in its context and the excessive risks that these were accompanied by.

Financial crises often lead to regulatory backlashes. The Wall Street Crash of 1929 was one example of that and the crisis that began fermenting in 2007 was to be no exception. The recent adoption of the Alternative Investment Fund Managers (AIFM) Directive, in Europe, and of the Dodd-Frank Act, in the US, are said to support the claim that financial crises provide opportunities for reforms with little (or no) link to the root causes of the crises themselves. While it is probably true that the financial crisis was not directly caused by hedge funds, nor was it the product of the market activities of private equity or sovereign wealth funds, these and other alternative investment vehicles are very much the products or manifestations of the deregulation trend that swept through financial markets in the last two decades. The new regulatory frameworks that alternative investment funds are now preparing for, on both sides of the Atlantic, are, thus, not as unwarranted as some would have one believe, however legitimate it may be to disagree on their precise scope and concrete contents. For, in the run up to the crisis, alternative investment funds have been beset by a litany of shortcomings, common to their more conventional competitors, including failures in management, oversight and control, asset segregation and valuation, as well as transparency, contributing to

corporate governance distortions, the exacerbation of market risks and the accentuation of systemically significant imbalances. Similarly, the pre-crisis liberalization of alternative investment products and the policy makers' surge to widen investment choice for retail investors were symptomatic of the same financial deregulation trend that helped usher in one of the most catastrophic sequences of events to hit financial markets in recent history. In the same vein, alternative investment managers were to prove no more capable of grasping the full significance of their regulatory and societal responsibilities (those that the abdication by governments of their own role allowed room for) than their peers from the more stringently regulated banking and mutual fund sectors, while their clients, however experienced and sophisticated, were to fall no less victim to momentous errors of appreciation and to show no sounder judgement than the clients of other market intermediaries. That rules in the field of alternative investment funds have become the focus of particular attention and that wide-ranging regulatory changes have been proposed or enacted to help address the weaknesses brought to light by the financial downturn should, therefore, not come as a surprise, even if it is possible to disagree on the concrete rules proposed for their regulation.

The policy issues that alternative investment funds raised, their perceived externalities – due to their involvement in speculative trading, their use of leverage and short-selling, their participation in spurious corporate governance practices, as well as their inadequate levels of disclosure and transparency, in conjunction with the opportunities for market manipulation that these are conducive to – combined with their potential for systemic disruptions, had been identified as concerns well before the onset of the financial crisis but never seriously addressed, despite the wide attention that they had attracted. The public scrutiny of the LTCM and Amaranth failures pointed to specific areas where vigilance was essential and action was necessary. However, the regulatory fall-out of those high-profile failures turned out to be very short-lived across the Atlantic, as the SEC's modest attempt to indirectly regulate hedge funds by imposing a registration obligation on their managers was defeated in court. In the EU, the Commission was to staunchly oppose hedge fund or private equity fund regulation until 2009. It took the financial crisis for policymakers and regulators alike, on either side of the Atlantic, to change their tune and acknowledge the existence of genuine issues at stake that had to be addressed as matters of urgency. It remains to be seen how successful their hitherto or future responses will turn out to be. That the opportunity for the imposition of normative constraints on alternative investment funds was to be provided by a major financial crisis, not directly attributable to their operation, inevitably increases the probability that those constraints

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will turn out to have been less the products of mature reflection and rather more the fruits of haste and urgency, with the regulatory process leading up to their adoption having, to some extent, fallen victim to the vagaries of political pressure and to the whims of public opinion. But on the need for action, as such, there is little room for dispute.

In light of the above, there has hardly ever been a more appropriate time than now to explore alternative investment funds, their merits and weaknesses, their *modus operandi* and their regulation. The aim of this book is to do precisely that, devoting to alternative investment funds the attention they deserve as an important, but often misunderstood or misrepresented, component of contemporary financial markets. To achieve that aim, this book is divided in four Parts. Part A (Chapters 1–4) provides the background information necessary to understand the contemporary alternative investment fund industry's profile. Part B (Chapters 5–11) is an account of some of the main areas of regulatory policy concern arising from the activities of alternative investment funds. Part C (Chapters 12–14) traces the history of the involvement of alternative investment funds in financial crises and outlines past failures, with a view to assessing the role of alternative investment funds in the former and the lessons drawn from the latter. Finally, Part D (Chapters 15–18) provides an account of alternative investment fund regulation in selected jurisdictions, including an overview of the expected impact of the Dodd-Frank Act and the AIFM Directive on the sector, on both sides of the Atlantic.

The handbook's introductory chapter discusses hedge funds, including the legal and business structures that are typical of this asset class in the US. Chincarini also compares hedge funds to other types of investment vehicles, such as private equity funds, mutual funds, and ETFs. The author then examines briefly the claims regarding the benefits of hedge funds as well as their relationship to the financial crisis of 2008. Chapter 1 concludes with a discussion of some of the regulatory developments across the Atlantic and whether hedge fund regulation is necessary or reasonable.

Chapter 2 provides a comprehensive overview of the European hedge fund industry, its structure, players, and major strategies, as well as its historical performance. Hankova and Lhabitant argue that, while the European industry remains heavily centred in London, recent efforts to tighten the UK tax regime, combined with the regulatory changes recently introduced at the EU level (such as the adoption of the AIFM Directive and the liberalisation of the regulatory framework for harmonized collective investment schemes), are likely to reduce London's appeal as a management jurisdiction of choice. The authors also find that, compared to their US counterparts, European hedge funds under-perform; that the common belief that smaller funds outperform larger ones is unfounded;

and that the financial crisis has brought substantial changes to the *modus operandi* of European hedge funds, increasing the likelihood of further consolidation within the sector.

Chapter 3 is devoted to sovereign-wealth funds (SWFs), from the start of the previous decade until the onset of the financial crisis, a period which has seen SWFs emerge as an important investor group, providing much needed liquidity, including at times of crisis. Das argues that the concerns about SWFs and their activities voiced prior to the start of the financial crisis were exaggerated or misplaced, and that the focus of the debate surrounding them has in any event shifted since the start of the crisis. Going forward, it is important to ensure that the market turmoil, and the change of priorities that it has signalled, do not deflect attention from the need for improvements in their transparency, so as to alleviate concerns about their activities and avert the risk of a protectionist backlash. The author outlines some of the policy measures available to ensure a balance between more transparency and accountability in the operations of SWFs and the avoidance of unnecessary strictures on their activities.

Chapter 4 provides a comprehensive review of the literature on the risks and returns of private equity funds, comparing the different datasets used in academic research. Phalippou finds that average returns are lower than those of public equity and, in any event, less spectacular than often conjectured. The author also finds that buyout funds appear to bear a moderate market risk, although their exposure to liquidity and distress risk is significant. Phalippou conjectures on why industry benchmarks show different returns than those documented in Chapter 4. Finally, he discusses the issue of fund selection, emphasizing the importance of a bottom-up approach when investing in private equity, showing that top-quartile returns and evidence of performance persistence are to be approached with caution, and describing variables that can help predict returns.

Part B of the book begins with Chapter 5, which explores the rationale for allowing retail investors' wider access to alternative investment products, focusing, in particular, on the FSA's response to pressures for wider retail investor access to such products. McVea describes the new regulatory landscape, which has emerged from the liberalization policy on retail investor access to alternative investments, and assesses critically the outcome of that policy, the contours of which are only now beginning to take shape. The author's basic claim is that while the EU's desire to create a 'state of the art' onshore investment fund industry is understandable and even laudable, there are serious shortcomings with the thrust of the EU's policy of liberalization in this sphere; and that regulatory authorities in Europe, and especially the UK, have placed too much faith in market discipline and tailored regulatory rules, despite their awareness of certain

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risks associated with greater retail investor access to alternative investment products.

The complexity of hedge fund investments poses challenges when it comes to a detailed analysis of their returns, a condition precedent for an adequate and comprehensive hedge fund reporting. Goltz and Schröder outline in Chapter 6 the major challenges for hedge fund reporting, providing an overview of the set of tools available to report the performance and risk of hedge fund investments. The authors examine the existing regulatory framework as well as guidelines and best practices issued by governmental working groups and industry associations on hedge fund reporting. They then take a closer look at the performance and risk measures currently used for hedge fund reporting, which, from a theoretical standpoint, are not always suitable. Finally, they examine specific issues of relevance to hedge fund disclosure, such as leverage, liquidity, and operational risk.

Over the last decade, activist hedge funds have emerged as significant agents of corporate change, capable of generating operational, financial, and wider governance reforms in their target firms. Chapter 7 reviews the objectives of hedge fund activists, their tactics and their choice of target firms. It then analyzes the value-creation process initiated by activist hedge funds, distinguishing the value effect from alternative hypotheses such as stock-picking and wealth transfer. Brav, Jiang and Kim conclude that the evidence available from different studies generally supports the view that hedge fund activism creates value for shareholders by effectively influencing the governance, capital structure decisions, and operating performance of target firms, instead of destroying value or focusing on short-term profits.

The recent hedge fund fraud scandals have raised questions about how wide-spread fraud in the industry is and to what extent the sector's opaqueness creates opportunities for unscrupulous behaviours. The recent high profile fraud cases have also re-ignited the debate on hedge fund regulation. The purpose of Chapter 8 is to synthesize existing research on hedge fund fraud. Focusing on fraud detection, Pool examines both the performance and the operational red flags proposed in previous studies. The author also discusses the effectiveness of these flags for fraud prediction and detection. The author claims that both operational and performance red flags relate to fund transparency and have important implications on current calls for greater regulatory oversight.

Chapter 9 reviews the pros and cons of external versus self-regulation in the context of hedge funds. Lamandini suggests that, despite the theoretically clear distinction between these two types of regulation, the practical differences between them are less prominent than one might have

assumed. Similarly, the deterrence associated with self-regulatory versus command and control rules is in practice not very dissimilar. As a result, self and external regulations are bound to coexist, considering the natural inadequacy of any national or regional institution, due to its territorially limited sovereignty, in properly responding to the regulatory challenges posed by genuinely global investment vehicles, such as hedge funds.

The final chapter of Part B examines the role that competition law could play in mitigating some of the risks associated with the activities of alternative investment funds. The financial crisis has seen many a commentator point to the destabilising effects of herding and correlated behaviour by financial market participants, linking those to price distortions and asset price bubbles. Chapter 10 inquires into those questions from the point of view of Union competition law, with particular reference to alternative investment funds. Harrison argues that applying competition law principles more rigorously in the financial services sector in general, and to alternative investment funds, in particular may reduce the need for detailed alternative investment fund regulation, while at the same time generating wider benefits for markets, their participants and investors alike.

Part C of the handbook begins with Chapter 11. This explores some of the most spectacular hedge fund failures in recent years, *inter alia* assessing the nature of the activities of hedge funds and how these were conducive to failures, their risk management practices and the role of supervisors in the run-up to their collapse and in their restructuring or recapitalization. As Jickling observes, drawing on the lessons of those failures, many of the dynamics that made the financial crisis so severe were anticipated in the reports issued in the aftermath of the collapse of *LTCM* and *Amaranth*. And yet, in 2007–2008, regulators were to prove unable to prevent those dynamics from materializing. Ironically, some of the major policy concerns raised by hedge funds and their activities were to be dealt with in response to the financial crisis, one in the creation of which hedge funds are generally considered to have played no more than a secondary role.

A discussion of the impact of hedge funds on systemic stability is a recurring feature of every financial crisis. Chapter 12 discusses the impact of hedge funds on systemic stability, first from a historical perspective and then in relation to the recent financial crisis. The analysis conducted by Strömqvist does not lend much support to the proposition that hedge funds have had a greater impact on financial crises than other investors, whether in general or specifically with regard to the recent financial crisis.

Chapter 13 addresses the thorny issue of the involvement of vulture funds in the recent sovereign default episodes within the EU. Traditionally associated with emerging economies, the threat of sovereign default has recently made its appearance in the context of several advanced economies,

including those of the Member States participating in the Economic and Monetary Union, partly as a consequence of the ongoing global financial crisis. The speculative activities of some private funds have *inter alia* been blamed for the sovereign default crisis in some of those Member States, attracting calls for their tighter regulation. Yeoh discusses the underlying reasons for the acute sovereign default risks faced by certain European Union Member States, and the possible impact of the activities of vulture funds on their emergence.

Part D of the handbook begins with Chapter 14. Since the end of 2008, lawmakers around the world have been grappling with the question of how best to react to the global financial crisis, with the outcome of their reflections also having an impact on the private funds industry. The Dodd-Frank Act, adopted in July 2010, is to radically change the landscape for the registration and regulation of private investment fund advisers – whether located within, or outside the US. In addition to significantly widening the registration requirements for investment advisers, the legislation and related implementing rules proposed by US regulators impose increased compliance, recordkeeping and reporting obligations on investment advisers. Other, entirely new, rules such as derivatives regulation, systemic risk regulation, and the ‘Volcker Rule’, may also deeply affect the operations of private fund advisers. Greene and Adams summarize, in this chapter, the pre-July 2011 legal framework applicable to investment advisers, before analyzing the groundbreaking changes brought forth by the Dodd-Frank Act, and its consequences for the private funds industry.

Chapter 15 addresses the issue of alternative investment fund regulation in Germany. Alternative investments in open-ended investment funds and, especially, hedge funds are topics of debate in recent political discussions. Lang argues that, surprisingly, there is no coherent political and regulatory discussion in Germany on how to build up a solid hedge fund industry while, at the same time, ensuring investor protection and financial stability. What is more, questions concerning investor protection are only being asked in relation to hedge funds and funds of hedge funds, ignoring the huge certificate-emitting branch, which presents the same inherent risks as hedge funds, but which operates in a less transparent manner and at a higher cost for investors.

Chapter 16 examines the growth and regulation of hedge fund, private equity and other types of alternative investment funds in Australia. The growth of investment in these alternative asset classes has been supported substantially by the retirement income system established in Australia in the early 1990s. Investment in alternative investment products has also been buoyed by almost two decades of uninterrupted economic growth and the ‘search for yield’, as well as by taxation arrangements. Erskine



outlines the overall size of the market, the number of investments marketed, the largest players, typical industry structures, the impact of the global financial crisis and some of the future challenges for the Australian industry.

Chapter 17 provides an overview of one of the most controversial pieces of European Union law in recent years: the AIFM Directive. Inspired by the perceived need to impose regulatory constraints on non-harmonized and, mostly, lightly-regulated funds, in response to the outbreak, in 2008, of the financial crisis, its earlier drafts were to cause controversy and deep divisions, with transatlantic ripple effects. The final rules, adopted in late 2010, were welcomed with relief by market players, for erecting less hurdles to market access than those originally proposed, and for imposing fewer obligations upon fund managers than the Commission had envisaged in its original proposal. However, the AIFM Directive remains a contentious piece of legislation, with wide-ranging implications for the way in which alternative investment funds are to conduct their business within the European Union in the coming years. Athanassiou and Bullman explore the merits and drawbacks of the Directive and reflect on its likely impact on the European and global alternative investment fund industries.

The final chapter of the handbook explores the probability that the recent financial crisis will prompt governments to establish comprehensive and effective global regulation for financial institutions. Viewing the history of post-war financial regulation through the lens of contemporary positive theories of regulation, Oatley and Winecoff conclude that the answer is 'no'. Although a case for global regulation can be made on market efficiency grounds, policymakers are less responsive to market pressures than they are to political incentives and the strong pressures that the latter create to retain national control over financial rules. The authors also argue that whilst crises trigger discussions and reforms, in each instance, adherence to global rules has been *voluntary* rather than obligatory and that the resulting agreements have failed to move towards anything that is even remotely akin to a global regulatory regime.

The law is stated as of 1 May 2011. Prospective changes are, where relevant, noted. Website citations were valid on the same date.

