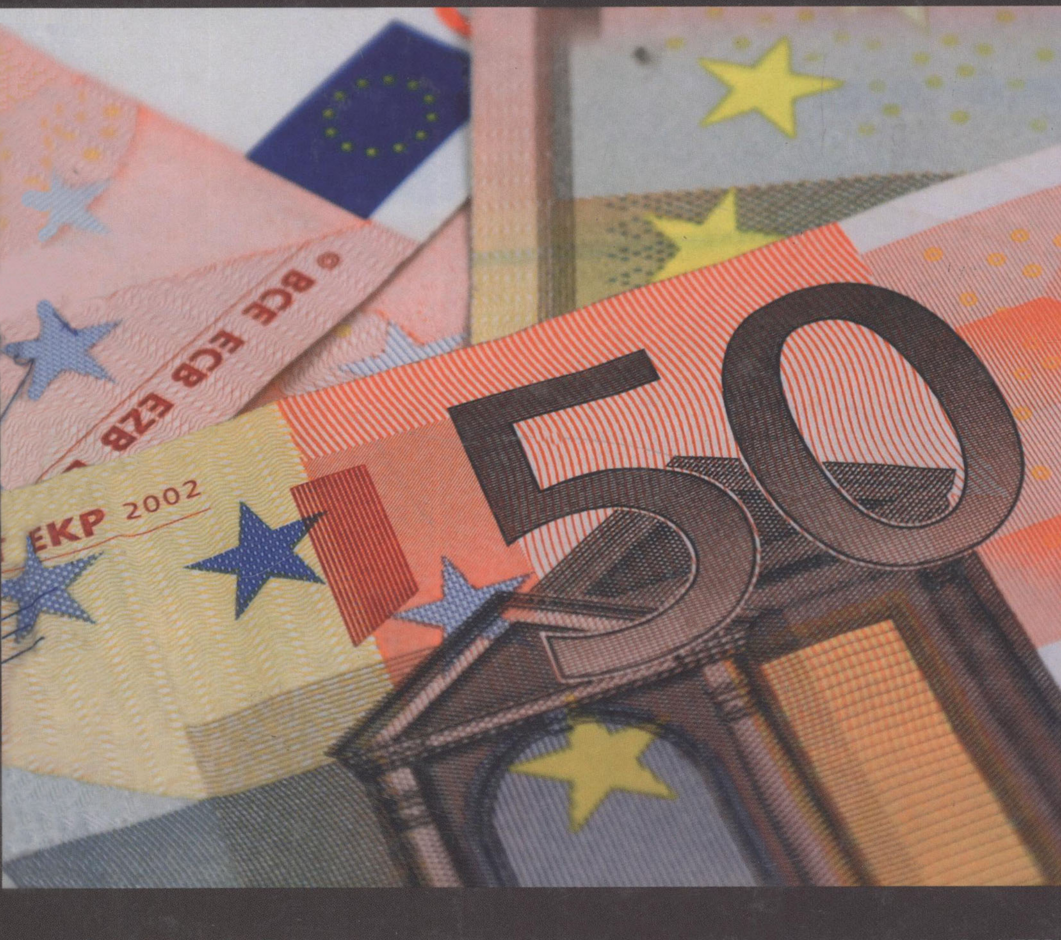
Research Handbook on Hedge Funds, Private Equity and Alternative Investments

Edited by Phoebus Athanassiou



RESEARCH HANDBOOKS IN FINANCIAL LAW

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RESEARCH HANDBOOK ON HEDGE FUNDS, PRIVATE EQUITY AND ALTERNATIVE INVESTMENTS

RESEARCH HANDBOOKS IN FINANCIAL LAW

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This important new *Handbook* series presents high quality, original reference works that cover a range of subjects within the evolving field of financial law. National, regional and global financial markets are at the epicenter of economic, political and social developments. They are shaped by their own intrinsic dynamics, but are also at the receiving end of potent external forces, including monetary developments, state regulation and policies towards international and regional financial integration and free trade areas.

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Research Handbook on Hedge Funds, Private Equity and Alternative Investments
Edited by Phoebus Athanassiou

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Abbreviations

ADI	Abu Dhabi Investment Authority
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AUM	Assets Under Management
ASX	Australian Stock Exchange
ASIC	Australian Securities and Investments Commission
BaFIN	Bundesanstalt für Finanzdienstleistungsaufsicht (Germany)
BIS	Bank for International Settlements
bop	Balance of payments
CAC	Collective Action Clause
CDS	Collateralised Debt Obligation
CEO	Chief Executive Officer
CFTC	Commodity Futures Trading Commission (US)
CEPRES	Center for Private Equity Research
CIC	China Investment Corporation
CRA	Credit Rating Agency
CRMPG	Counterparty Risk Management Policy Group
EDP	Excessive Deficit Procedure
EEA	European Economic Area
EME	Emerging-market Economy
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
ETF	Exchange-Traded Fund
EU	European Union
FAIFs	Funds of Alternative Investment Funds (UK)
FDIC	Federal Deposit Insurance Corporation (US)
FINRA	Financial Industry Regulatory Authority (US)
FoFs	Funds-of-funds
FoHFs	Funds-of-hedge-funds
FSA	Financial Services Authority (UK)
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council
FUM	Funds Under Management
GAPP	Generally Accepted Principles and Practices

GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GFC	Global Financial Crisis
G-7	Group of Seven
G-20	Group of Twenty
HFWG	Hedge Fund Working Group (UK)
HLI	Highly Leveraged Institution
HNWI	High Net Worth Individual
IAIS	International Association of Insurance Supervisors
IMA	Investment Management Association
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
IOSCO	International Organisation of Securities Commissions
IPO	Initial Public Offer
IRR	Internal Rates of Returns
KIA	Kuwait Investment Authority
LBO	Leveraged Buyout
LPs	Limited Partners
LSE	London Stock Exchange
LTCM	Long-Term Capital Management
MiFID	Markets in Financial Instruments Directive
MIS	Managed Investment Scheme
NAV	Net Asset Value
NPV	Net Present Value
NURs	Non-UCITS retail schemes (UK)
NVCA	National Venture Capital Association
OCC	Office of the Comptroller of the Currency (US)
OECD	Organisation for Economic Co-operation and Development
OFT	Office for Fair Trading (UK)
OTC	Over-the-Counter
PDS	Product Disclosure Statement
PE	Private Equity
PSI	Permanent Subcommittee on Investigations (US Senate)
PWG	President's Working Group on Financial Markets (US)
QIS	Qualified Investor Schemes (UK)
RBA	Reserve Bank of Australia
SEC	Securities and Exchange Commission (US)
SMSF	Self-managed Superannuation Funds
SRO	Self-regulatory organisation
SWFS	Sovereign Wealth Funds
TFEU	Treaty on the Functioning of the European Union

UCITS	Undertakings for Collective Investment in Transferable Securities
UK	United Kingdom
US	United States
VaR	Value at Risk
VC	Venture Capital

Preface and acknowledgements

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This book is dedicated to my family, those of its members who are no longer with us and those who are to hopefully take their place in the coming months and years.

Phoebus Athanassiou
Frankfurt am Main, Germany, 25 May 2011

Contents

List of contributors vii
List of abbreviations ix
Preface and acknowledgements xii

Introduction 1

PART A FOUNDATIONS

1 Hedge funds – an introduction 13
Ludwig Chincarini
2 Europe's hedge fund industry – an overview 63
Andrea Hankova and François-Serge Lhabitant
3 Sovereign-wealth funds – a paradigm shift in capital flows in the global economy 89
Dilip K. Das
4 Private equity funds' performance, risk and selection 113
Ludovic Phalippou

PART B REGULATORY ISSUES

5 Alternative investments and retail investors – a bold but risky experiment 141
Harry McVea
6 Hedge fund reporting 170
Felix Goltz and David Schröder
7 Hedge fund activism 195
Alon Brav, Wei Jiang and Hyunseob Kim
8 Hedge funds and the detection of managerial fraud 218
Veronika Krepely Pool
9 Self-regulation – what future in the context of hedge funds? 244
Marco Lamandini
10 Hedge fund regulation through competition law principles – some reflections 268
David Harrison

PART C ALTERNATIVE INVESTMENT FUNDS – FAILURES AND FINANCIAL CRISES

11 Lessons of Long-Term Capital Management and Amaranth Advisors 293
Mark Jickling
12 Hedge funds and their impact on systemic stability 309
Maria Strömqvist
13 Sovereign default risks in the Economic and Monetary Union and the role of vulture funds 332
Peter Yeoh

PART D COMPARATIVE PERSPECTIVES AND FUTURE PROSPECTS

14 US regulation of investment advisers and private investment funds – a concise overview 355
Nathan Greene and John Adams
15 German alternative investment fund regulation – wrong answers to the wrong questions? 379
Norbert Lang
16 Hedge funds, private equity and alternative investment in Australia 406
Alex Erskine
17 The EU's AIFM Directive and its impact – an overview 442
Phoebus Athanassiou and Thomas Bullman
18 The domestic rooting of financial regulation in an era of global capital markets 474
Thomas Oatley and W. Kindred Winecoff

Index 499

Introduction

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 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 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;