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## **WORKING DOCUMENT**

on Hedge funds and private equity

Committee on Economic and Monetary Affairs

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## 1) Introduction

The subject of this working document,<sup>1</sup> which represents the basis of the future ECON report, is the **investment vehicles hedge funds and private equity**. The document will examine what they are and the role they play in today's financial markets, including their impact on financial stability. The document will also look into any relevant relationships with other financial institutions as well as examine their impact on the real economy. It will summarise the existing regulatory and supervisory framework in order to look at potential and possible improvements at the stage of the draft report. The main focus will be on the European financial markets and the real economy, but it will also look at the global picture, especially at the offshore centres and the US.

It is important to state at the beginning of this document that hedge funds and private equity are **different sorts of investment vehicles** that quite often get confused. Although they are both lightly regulated private pools of capital that invest and compensate their managers with a share of the fund's profits, they differ in their investment strategy and in the products they invest in. The investment horizon of the hedge fund industry is usually much shorter in comparison to the horizon of private equity.<sup>2</sup> This document will describe each of the vehicles in more detail as well as the linkage between both investment vehicles and between their business models, which result in often symbiotic relation.

Easy access to debt financing with low interest rates and high liquidity, were present in the markets since 2000 to mid-2007 together with the search for higher yields by many institutional and other investors were the primary drivers for the recent expansion of hedge funds and private equity. Their share within the global asset under management (AuM) pool has increased substantially. In 2006, private equity amounted to over 1 trillion USD, 700 billion of which was LBOs.<sup>3</sup> This meant a 120 percent increase from 2000 and represented over 1.5 percent of global AuM of over 63 trillion USD. Hedge funds industry amounted for 1.9 trillion USD (up from 0.9 trillion in 2004) and represented around 3 percent of global AuM.<sup>4</sup> Not only amazing growth of their assets but also ever more intensive trading activities make these vehicles, especially hedge funds important market players. Although their weight in the markets increased, the same cannot be said for the levels of transparency.

### *1. a) Today's financial markets and real economy*

The promotion of **growth and employment** lies at the heart of the EU. As outlined in the Lisbon Agenda, our clear democratic political choice in the European Council has been to make the EU *"the most dynamic and competitive knowledge-based economy in the world"*

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<sup>1</sup> According to EP Rule 39, pursuant to Article 192 of the EC Treaty; the rule states that the EP may request the Commission to submit to it any appropriate proposal on the subject. The report however has to establish that no such proposal is under preparation (not included in the Commission's annual legislative programme) and that the Commission has not responded positively to earlier requests from EP. The report will thus have to indicate the appropriate legal basis and be accompanied by detailed recommendations as to the content of the required proposals. It will have to indicate whether there is a need for additional financial resources.

<sup>2</sup> De Vries, Casper, Stork, Philip, Hedge Funds and Financial Stability, Erasmus University Rotterdam, ECON Study, IP/A/ECON/ST/2007-16, p. 8.

<sup>3</sup> The ECB estimate is even higher (80 percent).

<sup>4</sup> The Economist, Report on Asset Management, 1 March 2008.

*capable of sustainable economic growth with more and better jobs and greater social cohesion, and respect for the environment by 2010*". The European Parliament has on several occasions expressed its backing of this ambition - most recently in its resolution on the Integrated Guidelines for Growth and Jobs of 20 February 2008<sup>1</sup>. The Slovenian Presidency has committed to implement those priorities and creating a stronger economy with prosperous, fair and environmentally sustainable future for Europe. To achieve the aim of the Lisbon Strategy, we must ensure an increase in long term investment to promote R&D, innovation, strong market position, continuing education and qualified workers. In this context, it is vital to provide better long-term financing conditions for the private sector, especially SMEs, including start-ups, where cross-border availability of risk capital (such as venture capital) is of paramount importance.

In reality however, rather than an increase in long-term investments, there has been a relative decline in investment in the capital stock by corporations. Many different factors are playing a role here. There seems to be a growing global consensus that the **interplay between the financial markets on one side and the real economy on the other** is not functioning in an optimal way. Market failures, conflicts of interests and imperfections on increasingly globalised financial markets have in the last two decades lead to increasingly frequent and costly financial crisis. Especially mis-pricing and information asymmetries, fuelled by already mentioned low levels of transparency enhanced the market disruptions.

The costs for the real economy are simply too high in terms of jobs, of long-term investments (including pension related savings) and of long-term competitiveness of European companies. Currently, as a direct consequence of financial market instability and the following liquidity squeeze and credit crunch, international institutions like the OECD, the IMF, the ECB and the European Commission have been adjusting downwards their economic growth prognosis.

### *1. b) Current Crisis*

The current financial crisis was triggered by the sub-prime market in the USA, but it has then expanded to the whole financial system. Stock markets all around have suffered significant losses, central banks had to inject money into the market to counterbalance the lack of liquidity during the growing credit squeeze.

Regarding the trigger of the recent crisis, it should be noted that the US sub-prime sector has been either only **lightly regulated** (mortgage brokers) **or not regulated at all** (such as *conduits*<sup>2</sup> issuing structured products backed by sub-prime asset backed securities). These vehicles, which regulated banking institutions increasingly used to repackage their liabilities, proved to hold weak capital, no deposit base and were not regulated at all. Moreover, the rating of their asset (mortgage) backed structured products they sold to investors was undertaken by credit rating agencies (CRAs), which are also non-regulated entities. Thus as a result of the crisis, the U.S. Treasury and U.S. regulators decided to subject all the mortgage

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<sup>1</sup> European Parliament resolution of 20 February 2008 on the Integrated Guidelines for Growth and Jobs (Part: broad guidelines for the economic policies of the Member States and the Community): Launching the new cycle (2008–2010), P6\_TA-PROV(2008)0058.

<sup>2</sup> A financial intermediary, such as traditional Special Purpose Vehicle (SPV) or Special Investment Vehicle (SIV) or Security Arbitrage Conduit (SAC) using risk securitisation techniques: they buy loans and issue tranch debt (such as asset backed commercial papers).

brokers to a nationwide licensing system, to require from CRAs to disclose conflicts of interest, distinguish more clearly between the ratings they gave to structured credit products and ordinary debt, to ask additional information from the issuers of mortgage backed securities as well as to revisit Basel 2 rules on off-balance sheet exposures to conduits as well as to encourage banks to issuer covered bonds to finance mortgages kept on their books as alternative to securitisation into mortgage backed securities.<sup>1</sup>

Nobody yet knows the full magnitude this crisis will have, but the negative effects of past financial crisis on the real economy are well documented and are worth remembering. *“Fiscal costs of cleaning banking crisis can be enormous. The fiscal cleanup from Sweden’s 1991 crisis was 6 percent of GDP and Norway’s 1987 crisis was 8 percent. Spain’s post-1977 cleanup cost over 16 percent of GDP. Estimates for Japan’s bill vary widely, with many in excess of 20 percent of GDP”*.<sup>2</sup>

Regardless of whether has been the demand for leveraged products with high risk or the supply of them that caused the turmoil, the question is whether their existence contributed to the real economy more that it may consequently damage. Recognising that there is not only one single factor or culprit the current crisis, it is important to recognise that all the actors played their role and that we need to improve many aspects and levels of their structures and functioning in order to improve the efficiency of financial markets as well as their robustness when facing problems. With the current financial turmoil there has been increasing **global concern** among central banks, legislators and regulators, supervisors and international financial institutions about **financial stability** and the reduction of systemic risk. The conclusions of the G8 Summit in Germany in 2007 as well as the October ECOFIN Conclusions and also the latest reports by the International Monetary Fund (IMF), the Financial Stability Forum (FSF) and the ECB highlighted the need to address the complex financing structures used by non-regulated entities as well as by regulated financial institutions. Discussion on the role of conduits, highly leveraged investors, complex financial products such as credit derivatives (like CDS<sup>3</sup>) or asset backed commercial papers (like CDOs<sup>4</sup>), pricing and the role of the CRAs, bonuses and compensation schemes for traders and executives have among others been at the top of everyone's agenda since Summer 2007.

Therefore, this document will **also look at the behaviour of private equity and hedge funds** in the current crisis and examine their behaviour in worsened credit market conditions.

#### *1. c) Objectives of this working document (and later of the draft report)*

Against the background described above, this working document will try to examine the

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<sup>1</sup> FT.com, 13 March 2008.

<sup>2</sup> Reinhart, Karmen, Rogoff, Kenneth: "Is the 2007 U.S. Sub-prime Crisis so Different?", p. 4, Draft of 5 February 2008, Harvard University, Maryland University and NBER.

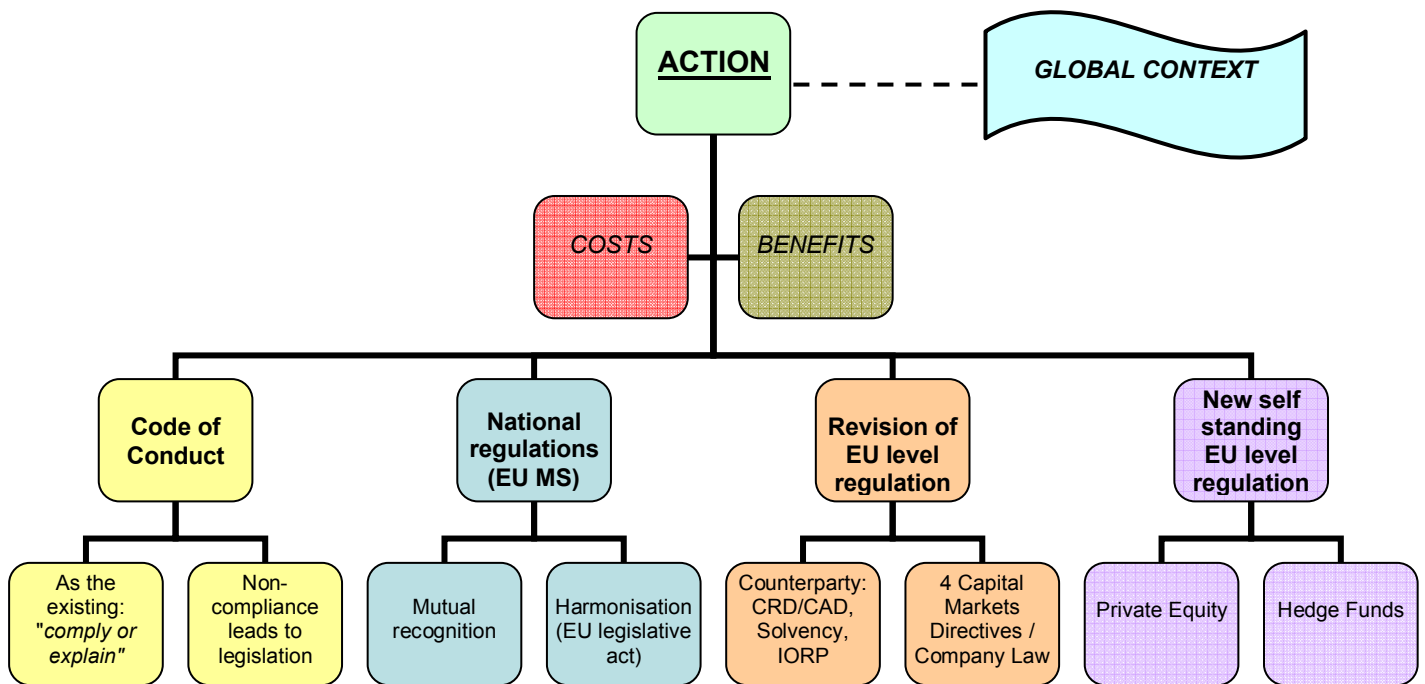
<sup>3</sup> Credit Default Swaps: default triggered credit derivatives. The owner of a fixed income product buys credit protection for the product from the seller of the swap. The latter thus guarantees credit worthiness of the product in question by taking over the credit exposure. When settled, the (protection seller) pays the protection buyer the difference between the reference face value of the asset (fixed income product) and the price of the defaulted asset. The settlement is usually physical (cash).

<sup>4</sup> Collateralised Debt Obligations: a structured credit security backed by a pool of diversified securities (=cash CDO), loans (=Collateralised Loan Obligation) or credit default swaps (=synthetic CDO), where securitized interests are divided into tranches with differing repayment and interest earning streams.

following **5 questions**:

1. Is the current level of **transparency** sufficient? In the case of hedge funds, is it sufficient for investors, for supervisory authorities, for the public? In case of private equity, is it sufficient for investors, for supervisory authorities, for the public as well as for the portfolio company? Are there any **asymmetries of information** inherent to the sectors?
2. **Indebtness**: is their level of leverage too high? If so, why is this problematic?
3. What is their direct or indirect link to the **current credit crunch** following the sub-prime crisis and in this context, what are the relevant links to other players in financial markets, how are they structured and what are potential conflicts of interest?
4. Do either hedge funds or private equity within current regulatory and supervisory design contribute to smooth functioning of **financial markets** and thus enhance their stability? How does this relate to the structured credit products such as CDOs?
5. Do they contribute directly or indirectly to the real economy and in the EU context to the long-term goals of the Lisbon Agenda, especially to the competitiveness and viability of companies and their **long-term investments**? Also, are there undesirable effects on workers rights and working conditions?

*If any of the above proves to be problematic, what regulatory or any other form of action would be best to improve the current situation?*

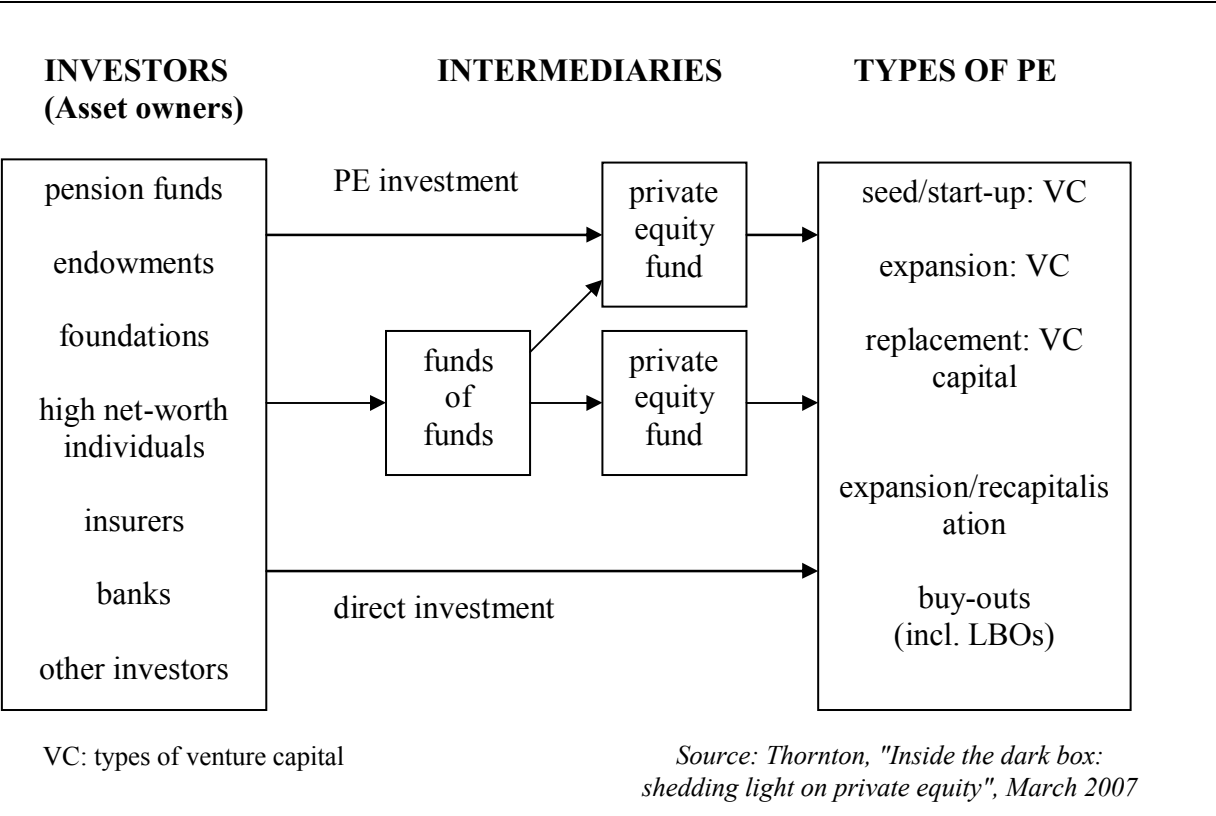


## 2) Private Equity

Description and business model

General

Private equity investment funds are "private" in the sense that they are not listed and derive their capital from investors outside of public capital markets. They are "equity" funds in that, typically, they acquire equity in the investment target with a view to holding the investment (minimum 2 years, as a general rule). They may be sub-divided into **venture capital** (used to finance new businesses), **expansion capital** (to fund the growth of existing businesses) and **buy-out funds** (which typically seek to take an existing public company private). The latter are almost always so-called LBOs and they amounted to over 80 percent of all private equity business in 2006, up from 65 percent in 2004.<sup>1</sup> The diagram below illustrates the broad structure of the private equity industry.



Leverage/Indebtedness and the current credit crunch

Private Equity firms are specialized in raising funds to take over the totality of the equity of the target company - private equity. But a private equity firm herself may be listed on a stock exchange, as we have seen recently in the case of Blackstone. Since the buy-outs and among them the leveraged buy-outs (LBOs) represent the main bulk of the private equity business, the leverage is the key to their business model. Thus in addition to the funds they raise from investors (the capital of the private equity fund), the managers almost always take on debt (leverage) to make an investment. Traditionally, banks provided LBO funding (on average over 50 percent in 2006<sup>2</sup>); either via syndicated loans to reduce their exposure to LBO deals

<sup>1</sup> "Large Banks and Private Equity-Sponsored Buy Outs in the EU, ECB, April 2007, p. 12.  
<sup>2</sup> "Large Banks and Private Equity-Sponsored Buy Outs in the EU, ECB, April 2007, p. 12.

or off loaded the exposure on secondary markets, where repackaged loans were sold to investors (including hedge funds). However, the current credit crunch has made banks reluctant to provide this type of finance, both because of their general reluctance to lend at present and, more specifically, because they have not been able to sell-on existing LBO debt on their balance sheets (the FT estimates that there is currently around USD200 billion of impaired LBO debt held by banks<sup>1</sup>).

Apart from the bank loans, LBOs used other sources of funding, some of it normal equity, some also in a form of debt or loans which increased leverage (like mezzanine debt, shareholder loan etc). After the LBO has taken off, the managers often took additional debt capital calls, thus further leveraging the company (recapitalisation).

Since many sources of refinancing have become scarce in the past half a year, private equity managers are seeking financing from others. They have identified sovereign wealth funds as a prime new source of LBO funds.<sup>2</sup> Hedge funds themselves are another source of LBO funding (e.g. in funding Hellman & Friedman's purchase of Goodman Global, the US manufacturing group, in October 2007). Private equity managers have even identified pension funds and mutual/investment funds as sources for LBO funding. However, it remains difficult to find financing, especially for highly leveraged private equity funds, as proven in the case of Carlyle Capital, which having failed to meet received margin calls then faced the foreclosing of lenders on the mortgage backed securities collateral. The lenders were simply not willing to provide additional financing and thus the remaining assets are simply to be distributed among them and the fund is to close.<sup>3</sup>

### *Investors in private equity*

Investors in private equity may comprise any of the categories of investors in non-public funds, including institutional investors. So, in addition to wealthy individuals, university endowments (especially in the USA) and charitable foundations, pension funds, mutual/investment funds and insurers invest in private equity. Thus many workers and pensioners are exposed to private equity (if their pension fund invests in private equity), as are many consumers (via pooled investment or insurance products). To the extent that pension funds and mutual/investment funds provide "LBO finance" (see "Leverage/indebtedness" section above), the individual workers and retail investors relying on these funds will also be exposed to the private equity market. Moreover, and unlike the time periods for hedge fund investment, private equity investors typically have to agree to their money not being available for a relatively long period ("lock-up" periods are typically 2 years and may be longer).

### *Profits*

Profits are made from dividends but also from any capital profit upon exit (i.e. on selling the target company to new owners). The exit can be done by initial public offering ("IPO") - returning the shares to a public equity market - but, more commonly in recent times, the exit

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<sup>1</sup> Financial Times, 27 February 2007

<sup>2</sup> As for example the China Investment Corp. stake in Blackstone Group LP (1 percent of its listed operation and Abu Dhabi Mubadala Development Corp. bought 7.5 percent stake of Carlyle Group.

<sup>3</sup> Reuters Limited, 13 March 2008.

is by secondary buyout, where one private equity fund buys from another<sup>1</sup>, trade sales to another corporation or recapitalisation. Hedge funds also play a role in secondary buy-outs as well as recapitalisation since they often provide financing, mostly in the form of subordinated debt.

### *Remuneration of private equity managers*

Private equity managers (called the "general partners") pay themselves their fees out of the profits of the investment, sometimes ahead of the investors (often known as the "limited partners"). The general partners usually receive management fees of around 2 percent of the fund's assets and a share of any capital profit on exit (the "carried interest") of usually 20 percent. In addition, some private equity investments (such as recapitalisations) are structured so that debt is used to pay the managers their remuneration early, ahead of the investors getting any return and regardless of their performance in managing the target company; as the FT put it in 2006 "what a recap essentially does is let a buyout group extract dividends early in the life of their investment. That allows the financiers to pay themselves fat bonuses."

The Wharton study also showed that the funds earned close to 20 percent on fees alone. The results of the study, incorporating records from investments in no less than 144 individual funds over the period 1992-2006, showed fees on "carried interest" - the percentage of the profit resulting from the sale of the company and/or dividends - yielded on average 5.41 percent of the funds under management, but accounted for only around a quarter of the total fees raked in. Management fees associated with the acquisition (levied on the acquired company), exit and other creative advisory/operational fees brought the average fee revenue to a whopping USD 19.76 for every 100 dollars under management.<sup>2</sup>

### Positive impacts

#### *Start-ups and SMEs*

The Lisbon Strategy emphasises the vital role of SMEs, both new "start-ups" and existing businesses. The European Commission has identified venture capital as a crucial source of funding to meet the Lisbon agenda.<sup>3</sup> Private equity firms are in a position to fulfil this traditional venture capital role, supplying capital for new and high risk business ventures when more traditional suppliers of business finance (like banks) will not. However, as already indicated the large chunk of private equity business is LBOs and not traditional start-up or growth capital.

#### *Improved Management*

Private equity managers often claim to improve the value of target companies by replacing or improving its management. This may, in turn, increase the target company's contribution to the real economy. Although it is difficult to test this assertion with the data available, private

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<sup>1</sup> Barclays estimates that secondary buyouts represent around 40 percent of total buyouts in the UK, Standard and Poor's estimate is 45 percent.

<sup>2</sup> Metrick, Andrew and Yasuda, Ayako: "The Economics of Private Equity Funds", The Wharton School, Department of Finance, September 2007.

<sup>3</sup> Report, 21 December 2007

equity proved beneficial for certain types of businesses such as family business, where it can in addition to funding provide advice on how to improve performance, how to find a balance between fractions of the family and also puts a price tag for the company, which can help some members of the family to exit if they wish.

### Negative real economy impacts

#### *Leverage*

It is not unusual that a leveraged buy-out is financed by 20 percent capital share from the private equity fund and 80 percent debt capital. Almost always this debt burden is transferred to the target enterprise. In the UK the debt/EBIT ratio of the five largest transactions to June 2006 was 6.41. The FSA described this figure as “*high relative to ... leverage levels observed in large deals historically*”.<sup>1</sup> The Bank of England estimates that, following recent buyouts, “*the UK corporate default rate could be up to 0.8 percentage points higher on average over an economic cycle*”.<sup>2</sup> The link to the current credit crunch is clear. Even if this debt burden was bearable in the recent more benign economic climate, the credit crunch means the cost of the debt is likely to increase and the possibilities for re-financing are likely to reduce. This in turn increases the risk that the target company will go into liquidation. In such a case it not just the investors who lose; the employees of the target are obviously affected, as are other stakeholders, like customers and suppliers.

The leverage problem has already started to crystallise. According to the Wall Street Journal<sup>3</sup>, the average price of these loans has fallen to levels that in a normal period would indicate bankruptcy. Defaults are now creeping up and lender interest is diminishing, because their return is linked to short term interest rates (which are falling).

#### *Capital depletion in target companies*

Excessive leverage carries the additional risk that the managers adopt an excessively short-term time horizon. LBO investors, in particular, often have a short-term perspective (2-4 years, even less) meaning that their funding is not permanently available to the company. These features of private equity are at odds with the Lisbon agenda's long term investment aims. So also are other features of private equity that deplete the target company's capital (e.g. excessive dividends to remunerate the private equity managers; transformation of target company capital into debt through the removal of undisclosed reserves and the sale of assets). Lost capital represented by these assets could otherwise serve as a buffer in the event of a market slump or be used for investment in the enterprise. In Denmark, the TDC telecommunications company was taken over by a group of private equity firms in 2005, with 80 percent of the purchase financed by borrowing. The company's assets-to-debt ratio leapt from 18 percent to 90 percent as company reserves for long-term development – essential in the telecoms industry – were used to pay the debt!

Private equity firms can off load risk to the target company also due to their legal structure

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<sup>1</sup> Speech by Sally Dewar, FSA, to the British Bankers Association, 25 January 2007

<sup>2</sup> Bank of England, Financial Stability Report, April 2007.

<sup>3</sup> Wall Street Journal, 11 February 2008

(limited liability company or partnership). The legal agreements when taking loans are most often between the lender and the target company and not between the lender and the private equity firm.

The IMF predicted that in a more challenging environment private equity deals, especially LBOs, will have poorer performance than publicly owned companies.<sup>1</sup>

### *Employment*

Aside from the risk to employment and working conditions that excessively leveraged private equity investment brings, other private equity investment may also lead to lower employment in the target company. A recent World Economic Forum working paper assessed that “five years after the transaction, the targets have a level of employment that is 10.3 percent lower than it would be if targets had exhibited the same growth rates as controls”<sup>2</sup>. In 2006, the German energy multinational RWE sold Thames Water to Macquarie Infrastructure. At the same time it announced that the workforce of Thames would be reduced by 15 percent by 2010. Also, the UK Automobile Association was bought by private equity in 2004. The AA had made a profit of £75m and was providing an expanding service with 10,000 staff. Annual profits have gone up to £190m while 6,000 workers have been laid off, and both costs and waiting times for AA members needing its vehicle repair and recovery services have increased.

### *Reduced tax take*

Private equity funds are largely exempt from paying tax, often because they are registered offshore (although of course they have to operate from the world's major onshore financial centres). One fund manager has admitted that he pays less tax than his cleaning lady. In the US, it has been calculated that the funds involve a tax loss to the country of \$2-3bn – three times the EU budget for humanitarian aid. In several EU jurisdictions (such as the UK) the returns to private equity managers may be subject to special, lenient tax arrangements. In particular, returns may benefit from tax provisions making interest payments (e.g. on leveraged buy-outs) tax-deductible and from tax provisions treating the profit to the managers as capital gain rather than income. In summary, the tax advantages given to private equity managers reduce the tax take, implicitly requiring cross-subsidy by ordinary tax-payers.

In addition to the lenient taxation on funds and managers profits, there is an implicit incentive to leverage the target (portfolio) company since equity is taxed, but debt not. Loading their balance sheet with debt the debt is in implicit tax subsidy resulting in companies of poor financial health and in reduction in public revenue at the same time. Thus benefiting the debt providers instead of enabling the governments to finance implementation of the Lisbon goals such as better education, infrastructure and research.

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<sup>1</sup> Global Financial Stability Report, September 2007, p. 17, Table 1.2

<sup>2</sup> Davis et al, "Private Equity and Employment", Presented at the annual meeting of the World Economic Forum, Davos, Switzerland, 25 January 2008.

### *Transparency issues*

Although pensioners, workers and consumers may be exposed to private equity via their investments, pension funds or insurers, they do not benefit from the same degree of consumer protection and other regulation that applies to other financial services. In many cases of LBOs, transparency and information are scarce, and LBO strategies after an acquisition pose risks of deterioration in corporate governance.

Generally, private equity funds are opaque and not transparent: for example, they are not quoted on public stock markets and thus are not subject to their disclosure rules. The opacity of private equity - so far as the public authorities responsible for financial stability and orderly markets are concerned - brings with it similar issues for those public authorities, and, thus, for financial stability, as are discussed in relation to hedge funds.

### *Conflicts of Interest*

In the private equity business, there are often conflicts of interest. The FSA has identified several situations where these can occur, namely, those affecting the general partner (differing levels of investment in the target companies, managing several funds at different life cycles investing in the same target company, sitting on the board of directors of the target company among others).<sup>1</sup> There is a major potential conflict of interest for target company managers who can see a huge personal gain for agreeing to a highly leveraged takeover. The management of a public company is clearly in a position to have better knowledge of – or even to negatively affect – the share price. This puts them in a stronger position than the shareholders (*see also Chapter 4*).

## **3) Hedge Funds**

### Description and business model

#### *General*

The concept of hedge funds represents investment vehicles, which use investment strategies, trading techniques and financial instruments that remain largely unregulated. They adjust rapidly to any change in the market conditions and are trying to explore market imperfections while seeking absolute returns, which are not correlated with stock and bond markets returns. In order to maximise those returns (but thus also losses), they borrow or trade in a variety of complex financial products, some with high leverage (derivatives, options) and engage in dynamic trading techniques such as short selling. Their investment strategies vary from event driven (like merger arbitrage, activist etc) to equity hedge (like market neutral, short bias etc), global macro or relative value (like fixed income-convertible arbitrage, volatility etc).

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<sup>1</sup> FSA, Discussion Paper on Private Equity, DP06/6, November 2006

Although all these features are usually not available to other (regulated) collective investment vehicles, many other financial institutions make use of some of them (as for example investment banks' proprietary trading desks).

As a legal entity, hedge funds are usually organised as a limited liability company or a limited partnerships. This allows them to leverage to a larger extent. Namely, when a fund invests in a company without any leverage, its own limited liability status does not matter. With or without limited liability, the fund can lose all of, but no more than, the value of its investment. However, if a fund borrows from a bank to invest ten or twenty times its own money in that same company, the fund's limited liability status makes a difference. It lets the fund profit from investment gains from much more money than they own, while risking no more than if not leveraged. This also bears relevance for the counterparty risk the lender to the fund (usually commercial or investment bank) is exposed to.

For all back-office (ancillary) services such as custody, hedge funds use fund administrators, mostly specialised business divisions of large banks (like Citigroup, HSBC, Fortis). Since the services are adapted to individual funds, most of the pricing matrices are as complicated as the hedge funds business itself.

### *Leverage*

There has been mixed evidence of the average leverage of a hedge fund. This is also due to their use of leverage, which can be two folded: directly through use of debt and indirectly through leverage embedded investment products (derivatives). Thus funds pursuing credit oriented strategies tend to have a higher degree of leverage. For example, Peloton, the hedge fund up for sale since February 2008 due to its losses in currently challenging credit markets was 4-5 times leveraged, owing money to 14 banks, which was described as normal for an average hedge fund.<sup>1</sup> Multistrategy fund Amaranth, which closed in September 2006 was estimated to be leveraged 7 times over.<sup>2</sup> Although Peloton actually made a profit out of the sub-prime crisis, the spill-over of the crisis affected the fund simply due its additional investments into the credit markets with their leverage simply too high to manage if any of the bets went wrong. This shows that regardless of the trigger, consequences of any financial markets crisis (that usually lead to lesser liquidity) will affect vehicles and institutions with higher leverage more than well capitalised conservatively run financial institutions.

### *Fee structure*

Fees are usually composed of a percentage of assets under management (management fee) plus a percentage of funds' annual profits (performance or incentive fee). The former amounts on average to 2 percent of the net asset value of the fund on the day of payment while the latter to 20 percent subject to high water marks and sometimes also limited by an agreed hurdle rate<sup>3</sup>. Total fees are not always indicated as clearly as they should and moreover, there are no penalties in terms of management fee if the level of return is less than expected or

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<sup>1</sup> "Peloton Partners in USD2bn assets sale", FT.com, 28 February 2008.

<sup>2</sup> IMF Global Financial Stability Report, October 2007, p. 68.

<sup>3</sup> High water marks: no performance fee unless the fund's value exceeds the highest net asset value it has achieved previously. Hurdle rate: contractually agreed minimum rate of return.

negative. Moreover in terms of performance fee, unless hurdle rates are negotiated, gains and losses usually remain treated differently.

### *The size of the industry*

Although absolute numbers of the industry size gives a good picture of its growth, it is important to note that hedge funds are now engaged in a broader range of activities than in the past, especially in the trading of credit instruments. They *"are also dominant players in several markets: in 2005, by one estimate, they accounted for 89 percent of U.S. trading volume in convertible bonds, 66 percent of volume in distressed debt, 33 percent of volume in emerging market bonds and in leveraged loans, 20 percent of speculative-grade bond volume, and 38 percent of credit derivatives volume. By early 2006, their estimated share of credit derivatives trading had increased to 58 percent."*<sup>1</sup>

Another aspect in the context of industry's size is market consolidation and concentration. In 2007, hundred largest hedge funds represented over two thirds of the hedge funds business (up from less than a half in 2004).<sup>2</sup> The latest ranking of largest hedge funds firms also indicates how deeply all players are getting into the hedge-fund business, especially already highly concentrated sector of investment banks like JP Morgan and Goldman Sachs (first and second with 33 and 32.5 billion USD in hedge fund assets respectively).<sup>3</sup> There is not one single big investment bank that does not have its own hedge fund.

### Positive aspects

Hedge funds explore opportunities in the financial markets, which are out of reach for more regulated financial vehicles. They take arbitrage opportunities and help allocate the capital better.

There is abundant evidence showing that hedge funds:

- own substantive proprietary market research which leads to better information and price discovery;
- provide incentives for innovative financial products;
- enhance diversification (contribute to dispersion of risk): they reduce correlations between assets in times of bear market, the evidence of the recent crisis is however not conclusive (*see also "Current Crisis"*);
- if and when they reduce correlations and act counter-cyclically in a crisis they can provide much needed additional liquidity and reduce volatility (*for reverse see "Financial Stability"*);
- increase competitiveness between market makers and intermediaries;

### Problematic aspects

#### *Transparency*

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<sup>1</sup> John Kambhu, Til Schuermann, and Kevin J. Stiroh: Hedge Funds, Financial Intermediation and Systemic Risk, Federal Reserve Bank of New York, Greenwich Associates 2006.

<sup>2</sup> The Economist, Report on Asset Management, 1 March 2008 (Hedge Fund Research Inc; and Alpha Magazine).

<sup>3</sup> Alpha Magazine, 31 December 2006, <http://www.alphamagazinerankings.com/hf100/rankings1.asp>

Since hedge funds operate in the shadows, with their business model based on exclusive information and investment strategies deriving from proprietary models known only to the manager, regulators and supervisory authorities face a dilemma: how to oversee their activities so as to protect both: the investors and the financial system, but not scare the business off to a more "friendly jurisdiction".

There are several dimensions to the question of transparency for hedge funds:

- supervisory disclosure and reporting for the purpose of prudential regulation (including the question of whether supervisory authorities should publish consolidated data they collect and if so to what extent);
- disclosure towards investors;
- disclosure towards other actors involved in the hedge funds business such as prime brokers;

We should look specifically into: regular disclosure of portfolio valuations (and its techniques), risk management techniques, internal governance rules, funds' fee structure (including total fee) as well as of any preferential arrangements such as *side letters* a fund might sign with some of the clients, leaving others (usually smaller) investors disadvantaged. Such arrangements can also include early redemption options and they constitute an obvious conflict of interest.

#### *End-investors and Retailisation (Consumer Protection)*

There are many new structured products linked to the performance of hedge fund indices or the funds of hedge funds being offered to retail investors. In addition, hedge fund investment techniques have also penetrated the retail market products such as sophisticated UCITS, certificates and similar.

Retail investors may not understand the risk of such products, even if sufficient information is given to them. The role of regulated distribution (intermediaries) is vital, but is difficult to ensure, especially given the ready availability of on-line sale of retail investment products. Although point of sale is regulated, the appropriateness and suitability principles (as in MiFID) are easily by-passed by the retail investors signed waiver. In addition, retail investors are indirectly exposed to hedge funds via institutional investors such as pension funds and insurance companies.

#### *Financial Stability and Systemic Risk*

Although there is no direct evidence that hedge funds are posing systemic risk, they do increase the volatility of financial markets in two ways: by herding and by exposure of other financial institutions to hedge funds.

**Crowding or herding and volatility:** hedge funds can enhance financial turmoil by withdrawing from their positions and exiting investments thus enhancing pro-cyclical behaviour. They also tend to be more vulnerable to any sharp movements than many other market players due to their leverage. The evidence of herding was Asian and ERM currency crisis where hedge funds ignored what their complex trading models were suggesting and

went with the crowd. Recently, the ECB tried to assess the crowding of their trades<sup>1</sup> but concluded that there is not sufficient information on investment portfolios to come to any conclusive evidence and that more transparency as to the portfolios is needed.

**Counterparty risk:** many banks and investment banks lend money to hedge funds. Given the partial overview these lenders usually have of overall funds' credit lines as well as problems of consistent valuation make the banks' exposure to hedge difficult to assess. The same goes for asset allocation by insurance companies and pension funds. Due to such a complex landscape of connections between the funds and other financial institutions, large failures can lead to the shaking of the systemic stability of the financial system.

### *Corporate governance concerns*

Another problematic characteristic, which is not per se linked to volatility, is the lax corporate governance of hedge funds and its investment managers. "*There is legitimate concern about hedge funds exploiting the separation of economic and voting rights. (...) The alarm has been raised by instances where hedge funds simultaneously benefited from a share price fall - on account of a net short economic position - while successfully exercising votes at a general meeting of shareholders.*"<sup>2</sup> Moreover, their investment time horizons are almost always short, since they exploit inefficiencies of financial markets rather than invest strategically. Thus they rarely add any long term real value to their investment targets. Moreover, some of the funds such as event driven activist (predatory) are looking for companies in distress, without an objective to invest and restructure.

### *Current Crisis*

World Economic Forum stated in its 2008 Global Risk report<sup>3</sup> that, rather than hedge funds, it was the structured products and off-balance-sheet vehicles of banks and investment banks, which created the current turmoil. The question is, however, not only whether hedge funds have triggered the crisis, but also whether they have managed to play their role (as always argued by the proponents) and went against the market, thus acting as a stabilising factor and provider of liquidity. If the argument of stabilizing role of hedge funds is correct, these should be the time when hedge funds should flourish in contrast to more regulated institutions, which need to adhere to stricter requirements of capital requirements.

They have been, on the contrary, several big hedge funds failures (*Focus, Peloton, Drake Management, GO Capital, Blue River*) with the most leveraged ones being hit the hardest and there are fears that more of them will face liquidity problems when trying to de-leverage or fail when seeking returns as high as promised to the investors. It is early days and the evidence of the recent crisis is not yet conclusive.

*Finally, it should be noted that many of the activities hedge funds engage in, are also undertaken by other financial institutions, thus any concerns raised should apply not only to*

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<sup>1</sup> ECB Financial Stability Review, December 2007, pp. 49-53.

<sup>2</sup> Naik, Narayan, Fung, William: "Hedge Funds: Transparency and Conflict of Interest", London Business School, ECON Study, p. V, IP/A/ECON/ST/2007-17.

<sup>3</sup> World Economic Forum, Global Risk 2008, January 2008, p.8.

*hedge funds vehicle but to every entity engaging in such activities (proprietary trading desk).*

#### **4) Other market participants**

The current system suffers from an unsustainable **information asymmetry**: currently, much information is provided by the public sector to the private sector; however certain parts of the private sector, like hedge funds in particular, provide practically no information, on their activities. This limits the public sector's ability to respond. Asymmetric information is inherent to today's financial markets and goes hand in hand with high level of concentration and oligopolies. As a consequence, audit firms, CRAs and big investment banks possess, in aggregate, much more information than the public supervisory authorities and central banks.

The relationships between **hedge funds and investment banks** deserve additional attention. Hedge funds have significant business relationships with regulated investment and commercial banks. The latter act as prime brokers (including financing trades), as well as provider of trading, sales and other services such as clearing and settlement, custody and even offering office space to hedge funds managers. There are estimates that hedge funds have provided investment banks with revenue of 40-50 billion USD in 2006, which was roughly around 15-20 percent of all industry revenues in investment banking, and equivalent to 4 percent of the assets under hedge funds management at the time.<sup>1</sup> There have been worries on possible conflicts of interest by regulators and supervisory authorities. One of the worries has been for the hedge funds to be receiving tips about pending mergers and other undisclosed news that could affect a stock price. Trading ahead of public disclosure would give a fund an advantage; while illegal, it is often hard for authorities to detect or prove.<sup>2</sup>

The relationship between private equity and investment banks is complex. There is a clear conflict of interest as the latter scoop high fees when financing and advising the deal as well as sometimes compete to buy the assets on offer.

Given that hedge funds invest in a lot of **Over-The-Counter** derivatives, it should be mentioned that there is a need to improve the information of what is happening on the OTC markets (decentralized market of securities not listed on an exchange). Perhaps Europe should reflect on something similar to the U.S. Depository Trust & Clearing Corporation (DTCC) establishing a giant data warehouse for these transactions,<sup>3</sup> which the U.S. is because of the current turmoil even thinking to enlarge via an industry cooperative on standardisation of OTC products and settlement.

**Sovereign Wealth Funds** (SWFs) are special agencies that manage part of the assets of sovereign governments. In the past years they have accumulated more than 2.2 trillion USD, a bit more than the entire hedge fund industry. The largest one officially is the Abu Dhabi Investment Authority, followed by Norwegian Government Pension Fund and Government of Singapore Investment Corporation. They tend to be investors with longer investment horizons, but also invest into more risky categories. The latter has been happening during the

<sup>1</sup> Dresdner Kleinwort: "Credit Swiss, Deutsche Bank, UBS: How important are hedge funds for the investment banking industry?", Dresdner Kleinwort Equity Research, 6 February 2007, p.8.

<sup>2</sup> International Herald Tribune, 2 January 2007.

<sup>3</sup> Naik, Narayan, Fung, William: "Hedge Funds: Transparency and Conflict of Interest", London Business School, ECON Study, p. 39, IP/A/ECON/ST/2007-17.

current credit crunch, where they proved to be a welcome source of capital when the banks liquidity dried up. Banks in need of recapitalisation, private equity funds seeking to raise money for new deals or to refinance old deals, as well as hedge funds, have been intensively courting SWFs in the past half a year. There is however a worry that these funds sometimes have political considerations, which could lead to investment decisions based on something else than simple risk and return and thus to price distortion and market disturbance. There have also been calls for more transparency on their size and allocation.

Linked to the business of structured products as well as to the current crisis **Credit Rating Agencies** (CRAs) should be addressed. There is an obvious conflict of interest inherent to their business model. They first earn fees from advising issuers in how to structure bonds and derivatives so that these receive the desired rating. They then have a not-so-subtle incentive to rate those issues in the promised manner.<sup>1</sup> Mounting defaults on sub-prime loans have led the SEC to look at the procedures for managing these potential conflicts of interest when CRAs handled ratings of residential mortgage-backed securities, which could have lead to mispricing.

## 5) Conclusions

### 5 a) Private Equity

#### *Transparency*

**Investors:** There is a need to review existing EU investor protection legislation (such as MiFID) to ensure that the appropriate level of protection is given to investors in private equity. For the workers, pensioners and consumers that are indirectly exposed to private equity, it is unlikely that existing EU investor protection legislation is adequate, as the directly exposed intermediary investor (such as the pension fund) will benefit from professional investor exclusions. Consideration needs to be given as to how best to extend the benefit of EU investor protection legislation to these vulnerable groups.

**Private equity funds:** similar issues arise as for hedge funds. The public authorities lack sufficient information on the extent, nature and ownership of private equity exposures. Again, existing EU prudential regulation (such as the Capital Requirements Directive) needs to be reviewed to see if it equips EU supervisors and other public authorities with what they require to discharge their financial stability and other responsibilities.

#### *Leverage/Indebtedness*

The leverage issue in private equity may require some analogue to existing thin-capitalisation rules in the tax field, but at the EU level. Limits might be set on the debt, with which private equity funds may burden target companies, which takes into account the legitimate interests of the stakeholders in those companies (such as its employees). Related to this would, ideally, be an EU level response to the tax concerns about private equity.

#### *Capital depletion in target companies*

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<sup>1</sup> Barry Eichengreen, "The mother of all emerging market crisis", 22/08/07.

The target companies, which private equity buy-outs take private, may suffer from depletion of their capital. There is a need to review existing EU law to see how this might be redressed. Again, it may be necessary to set limits on the depletion of capital in companies taken private through buy-outs.

### *Conflicts of interest*

There is a need to review existing EU investor protection legislation (in particular, MiFID) to ensure that the conflicts of interest that arise from private equity activities are appropriately regulated.

## 5 b) Hedge Funds

### *Transparency*

Although the sector's transparency has improved in the recent years mostly due to increased pressures of institutional investors such as pension funds or even funds of hedge funds, more should be done in the following areas in order to increase transparency:

- frequent reporting and disclosure with enhanced quality of information provided to the supervisory authorities, the investors and other counterparties (including information on risk profile);
- common global standards for portfolio valuation;
- common global standards for internal governance;
- better risk management with regular stress testing (fair value based<sup>1</sup>, taking into account operational risk and especially liquidity risk management in order to ensure that hedge funds do not have to exit all positions at once);
- enhanced counterparty risk regulation (through banking regulation such as CRD and insurance regulation such as Solvency II and pension funds regulation via IORP directive);
- more effective overall supervision monitoring implementation of capital markets directives: MIFID, MAD, Transparency and Prospectus;
- enhanced exchange of information and cooperation between supervisory authorities as well as between different tax administrations across EU and globally, especially as regards to the off-shore products;<sup>2</sup>

Complex matrix of existing EU directives and regulations together with different sets of national level regulation of hedge funds across Member States enhance the lack of transparency and seemingly high fees.<sup>3</sup> This lessens any commercial pressure to meet onshore standards and thus encourage offshore registration as well as investments in offshore rather

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<sup>1</sup> The risk of fair value accounting as used today is that when a true market price can not be found the money managers can set their own estimates of the value of the product. This showed in the case of two Bear Stearns hedge funds, which landed in troubles just before summer 2007. The fund's auditors warned that too high percentage of assets was valued using estimates and since the fund held only very low level of cash (1 percent) and the leverage was so high it lead to almost illiquid positions, demise was unavoidable (De Vries, Casper, Stork, Philip, Hedge Funds and Financial Stability, Erasmus University Amsterdam, ECON Study, IP/A/ECON/ST/2007-16, p. 68).

<sup>2</sup> See also EC Communication COM (2004) 611 final.

<sup>3</sup> See also: Naik, Narayan, Fung, William: "Hedge Funds: Transparency and Conflict of Interest", London Business School, ECON Study, p. iii, IP/A/ECON/ST/2007-17.

than onshore products (*the table in the Annex shows clearly how almost every piece of legislation touches upon the vehicles of private equity and hedge funds, but it is hard to see what the correlation matrix of all provisions may be*).

### *Valuation*

Hedge funds' financial instruments should be appropriately valued according to harmonised standards applicable across borders. They should adopt and operate robust portfolio valuation policies.<sup>1</sup> Furthermore, to avoid the pressure on managers when providing valuations of complex, illiquid instruments to administrators in times when performance has been poor (conflicts of interest), it is important to ensure independent valuation function or internal rules on possible conflict of interest if the manager is performing it.

### *Prime brokers*

The use of multiple prime brokers by single hedge funds means that none of them have the complete picture of funds risk profile. The latter is of paramount importance when calculating capital requirements. Funds should therefore be obliged to disclose its overall exposure to the investors, supervisors and prime brokers.

### *Financial Stability*

Specifically on financial stability and systemic risk is the question of whether there should be any set resolution mechanism available to regulators and central banks in case of a failure of systemically important hedge fund or a cluster of funds. Such mechanism could be triggered by either regulators or creditor banks, prime brokers or the fund(s) itself (themselves), and would then be obliged to bear the majority of the costs without use of public funds (as it was the case of LTCM collapse in 1998).<sup>2</sup>

### *Regulation/Supervision and Global Competitiveness*

Competition and a free market do not function in financial markets and especially credit markets to such an extent as one would wish. We need to be careful, however, that any regulation proposed would not stifle competition even further or limit innovation, support regulatory arbitrage or force funds and managers to move off shore due to high compliance costs. A good balance between hedge funds as stabilising and destabilising force needs to be sought for.

If the EU decides upon a stricter regulation, we could think of incentives for funds to stay on-shore, such as for example the establishment of an EU level legislative framework for cross-border marketing and sale of hedge funds (as also for other non-harmonised whole sale investment products).

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<sup>1</sup> There are several bodies, which recently published their work on valuation, such as IOSCO Principles for the Valuation of Hedge Fund Portfolios of 2007 and AIMA's Guide to Sound Practices for Hedge Fund Valuation of 2007.

<sup>2</sup> "Highwaymen or Heroes: Should Hedge Funds be Regulated?", Danielsson, Taylor and Zigrand, LSE and FMG, September 2005.

The very fact that hedge funds and private equity are now becoming very substantive and strong players in today's financial markets gives reason for **reconsidering regulation aspects**.

Although this working document does not yet aim to suggest specific legislative or other measures, which have been left for further deliberation in the Draft Report, the crucial question is: "*What is the rationale in having lightly or unregulated private pools of capital such as private equity funds and hedge funds operating in the market alongside tightly regulated institutions such as pension funds, insurance companies, banks and others?*"

**ANNEX: Legislative and Supervisory Framework**

<b>Relevant Existing EU Financial Services Legislation</b> ▼	Commercial Banks	Investment Firms	Insurance and Reinsurance	Occupational Pension Funds	Mutual Funds	Structured Investment Products	Investment Vehicles: Private Equity	Investment Vehicles: Hedge Funds
<i>CRD</i>	***				*	*	*	*
<i>CAD</i>	**	***			*	*	*	*
<i>Solvency I and II</i>			***	*	*	*	*	*
<i>IORP</i>			*	***	*	*	*	*
<i>MiFID</i>	**	***			*	**	**	**
<i>Transparency</i>	**	**	**	*	*		*	*
<i>Prospectus</i>	**	**	**		*		*	
<i>MAD</i>	**	**	**	*	*	*	*	*
<i>UCITS III</i>		*		*	***	*	*	*
<i>IMD</i>			***					
<i>Company Law</i>	**	**	**	*	*		**	*

\*\*\* main piece of legislation for the sector/institution/business

\*\* legislation of relevance for an important segment of the sector/institution/business (like distribution)

\* touching only certain aspects of the sector/institution/business or different across MS (like items under counterparty risk)

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*Capital Requirements Directive (CRD) (counterparty risk)* - embodies the Basel 2 regime of prudential regulation, including capital adequacy requirements determined according to risk. It also imposes ("Pillar 3") disclosure requirements. The CRD applies to banks and investment firms. Hence, it is potentially relevant to hedge fund and private equity managers incorporated in the EU. It will determine the capital that EU prime brokers must hold against their exposures to hedge funds. The CRD's most sophisticated methods for determining a bank's regulatory capital requirement became mandatory for EU institutions on 1 January 2008.

*Solvency I and II Directives (counterparty risk)* - Solvency I sets strict rules on investment policy for insurance companies, while Solvency II intends to adopt prudential regulation of principle risk based investment policy, similar to the CRD. It is expected that the latter will widen the possibility of insurance companies to invest in structured products, including alternative investment vehicles.

*IORP Directive (counterparty risk)* - regulating investment policy of pension funds. Relying on prudential regulation of principle risk based investment policy. The Directive is to be reviewed end of 2008.

*MiFID (Market in Financial Instruments Directive)* - is the principal EU investor protection legislation. It sets requirements concerning suitability, conflicts of interest and disclosure to investors (and regulates other aspects of investment firms' businesses). MiFID only came into force on 1 November 2007. Fund managers incorporated in the EU may be subject to MiFID unless they fall within one of the exemptions.

*MAD (Market Abuse Directive)* - covers insider trading and other illicit conduct concerning EU financial markets. It will apply to hedge fund and private equity managers regardless of their domicile when they transact in EU financial markets (e.g. when they trade in shares listed on an exchange in the EU).

*Transparency Directive* - requires notification of shareholdings that exceed 5 percent of the voting rights in the target company (with additional notifications as higher thresholds are reached). It applies also to borrowed securities. Member States may set lower thresholds (e.g. UK and GER apply a 3 percent minimum threshold). Hedge funds are subject to the directive if they invest above the threshold indicated.

*Prospectus Directive* - regulates the offering of certain financial products to investors in the EU. Public offerings require a prospectus meeting minimum disclosure standards; private placements are exempt. National implementation of this Directive varies and it is unclear whether "closed-ended" funds (such as most private equity funds) are subject to the Directive requirements in some Member States.

*UCITS III* - it is a product oriented directive, which regulates mutual funds, their investment policy, notification (EU passport) as well as their management company. Hedge funds and private equity are subject to regulation of UCITS III investment policy, which is open to closed end funds (private equity) subject to a list of criteria for transferability, liquidity etc as well as to hedge funds indices (also subject to certain criteria).

*Private Placement Regime* - proposal (Communication) to be published during 2008. It will

address cross-border placement of wholesale investment products (including private equity and hedge funds) for professional investors within the EU.

*Insurance Mediation Directive (IMD)* - regulating distribution of insurance products.

### **Other (non-financial services) EU Legislation**

*Company law directives* - insofar as they regulate capital levels in companies generally, these may be relevant to the capital depletion and leverage issues identified re private equity; especially 4th and 7th Company Law Directive (regulating consolidated accounts and annual accounts of public companies limited by shares or by guarantee and private companies limited by shares or by guarantee) as well as Banks and other Financial Institutions' Accounts Directive and Transfer of Undertakings Directive.

*Employment protection* - these laws may be appropriate for dealing with the employment issues raised re private equity.

### **National Legislation**

There are numerous legislative measures, which exist at the national level of EU member states and which can differ substantially. Individual Member States may impose their own requirements concerning hedge funds and private equity. For example, the UK (where the majority of hedge fund and private equity managers are located) imposes such requirements.<sup>1</sup> It is beyond the scope of this document to examine national legislation, but further information on comparison between different national regimes is available at several websites including IOSCO.<sup>2</sup>

### **Existing ECON reports**

The following Reports are relevant to the issues raised in this working document:

- John Purvis (EPP-ED) Report on "The Future of Hedge Funds and Derivatives";
- Ieke van den Burg (PSE) Reports on "Financial Services Policy (2005-2010) - White Paper" and "Financial Markets: The Current State of Integration in the EU";
- Wolf Klinz (ALDE) Reports on "Asset Management" and on "Asset Management II";

### **Codes of Conduct**

#### *HEDGE FUNDS*

- Hedge Fund Working Group (HFWG) (Large Group), October 2007
- Alternative Investment Management Association (AIMA)
- IOSCO (on portfolio valuation)
- Managed Futures Association (MFA)<sup>3</sup>

<sup>1</sup> See, for example, FSA, Discussion Paper on Private Equity, *ibid*.

<sup>2</sup> <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD213.pdf>

<sup>3</sup> US GAO has recently reviewed US regulation of hedge funds.

## PRIVATE EQUITY

- Walker Working Group Code of Conduct, November 2007
- EVCA revised Code of Ethics, April 2008