EUROPEAN PARLIAMENT

1999 *2004*

Session document

FINAL
A5-0476/2003

17 December 2003

REPORT

on the future of Hedge Funds and Derivatives
(2003/2082 (INI))

Committee on Economic and Monetary Affairs

Rapporteur: John Purvis

PR_INI

CONTENTS

Page

PROCEDURAL PAGE

At the sitting of 5 June 2003 the President of Parliament announced that the Committee on Economic and Monetary Affairs had been authorised to draw up an own-initiative report under Rule 163 on the future of Hedge Funds and Derivatives.

The committee had appointed John Purvis rapporteur at its meeting of 20 May 2003.

It considered the draft report at its meetings of 10 September, 4 November, 25 November and 2 December 2003.

At the last meeting it adopted the draft resolution by 16 votes to 4, with 10 abstentions.

The following were present for the vote: Christa Randzio-Plath (chairwoman), Philippe A.R. Herzog (vice-chairman), John Purvis (rapporteur), Pervenche Berès, Hans Blokland, Armonia Bordes, Hans Udo Bullmann, Jonathan Evans, Ingo Friedrich, Carles-Alfred Gasòliba i Böhm, Robert Goebbels, Lisbeth Grönfeldt Bergman, Mary Honeyball, Othmar Karas, Giorgos Katiforis, Alain Lipietz, Astrid Lulling, Hans-Peter Mayer, Ioannis Patakis, Fernando Pérez Royo, Bernhard Rapkay, Olle Schmidt, Peter William Skinner, Bruno Trentin, Theresa Villiers, Charles Tannock (for Christoph Werner Konrad), Harald Ettl (for Helena Torres Marques), Simon Francis Murphy (for David W. Martin), Elly Plooij-van Gorsel (for Christopher Huhne), Jas Gawronski (for Renato Brunetta pursuant to Rule 153(2)),

The report was tabled on 17 December 2003.

MOTION FOR A EUROPEAN PARLIAMENT RESOLUTION

on the future of Hedge Funds and Derivatives
(2003/2082 (INI))

The European Parliament,

– having regard to the implementation of the Financial Services Action Plan, in particular the European Parliament and Council Directive 2003/71/EC on prospectus to be published for securities[1], the European Parliament and Council Directive 2003/6/EC, of 28 January 2003, on insider dealing and market abuse[2]and the European Parliament position of 25 September 2003 on the proposal for a European Parliament and Council directive on investment services and regulated markets, and amending Council Directive 85/611/EEC, Council Directive 93/6/EEC and European Parliament and Council Directive 2000/12/EC[3],

– having regard to European Parliament and Council Directives 2001/107/EC[4] and 2001/108/EC[5], of 21 January 2001, on Undertakings for Collective Investment in Transferable Securities (UCITS) and especially Final Article 2 of Directive 2001/108/EC and Article 19(1) of Council Directive 85/611/EEC, of 20 December 1985, as amended by Directive 2001/108/EC,

– having regard to European Parliament and Council Directive 2001/65/EC, of 27 September 2001, on the valuation rules for annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions[6],

– having regard to European Parliament and Council Directive 2003/51/EC, of 18 June 2003, on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings[7],

– having regard to the capital adequacy rules and current review thereof,

– having regard to the IOSCO[8] report on regulatory and investor protection issues arising from the participation of retail investors in (Funds of) Hedge Funds,

– having regard to consideration of derivatives by the European Central Bank's task force on credit-risk transfer, the Basel Committee on the Global Financial System and the Joint Forum[9] working group on cross-sectoral supervisory co-ordination,

– having regard to current developments in national legislation in Europe, the US and Asia

---

[1] OJ not yet published.
[2] OJ L 96, 12.4.2003, p. 16.
[3] P5_TA(2003)0410.
[4] OJ L 41, 13.2.2002, p. 20.
[5] OJ L 41, 13.2.2002, p. 35.
[6] OJ L 283, 27.10.2001, p. 28.
[7] OJ L 178, 17.7.2003, p. 16
[8] International Organisation for Governmental Securities Commissions.
[9]A group of technical experts working under the umbrella of the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors.

covering hedge funds and derivatives,

– having regard to the European Parliament resolution of 22 September 1995 on financial derivatives: their present role on capital markets, their advantages and risks[1] ,

– having regard to Rule 163 of its Rules of Procedure,

– having regard to the report of the Committee on Economic and Monetary Affairs (A5-0476/2003),

<u>Concerning hedge funds</u>

A. whereas the term "hedge funds" covers a wide range of financial products, which might more appropriately be called "sophisticated alternative investment vehicles" (SAIVs),

B. whereas SAIVs provide genuine alternative means of investment that employ sophisticated techniques often in pursuit of absolute returns in all market conditions but operate with variable, sometimes very high, leverage, and can also risk substantial losses,

C. whereas a SAIVs regime could provide an appropriate regulatory home for other alternative investment funds**,** which do not necessarily pursue absolute returns, in areas such as property, currencies or commodities, and which are beginning to enter the European market but are currently unable to take advantage of a single EU-wide regime,

D. whereas the alternative funds sector has seen significant expansion since the LTCM crisis in 1998, with rapid growth in capital injected and assets handled, an increase in the number of smaller funds, including in Europe, and frequent concentration of funds in tax and regulatory havens,

E. whereas discriminatory taxes and regulations in some Member States have discouraged potential investment in foreign domiciled hedge funds, including those in other Member States,

F. whereas there is increasing interest in the investing public and from institutional investors to gain access to such investment options while being reassured as to their probity and good management,

G. whereas the innovative investment products and expanding investor choice offered by SAIVs are to be welcomed and encouraged,

H. whereas many of the requisite investment skills are available in the EU and are often deployed in managing offshore SAIVs and that the development of such skills should be encouraged,

I. whereas some Member States are considering special regulatory regimes to encourage such undertakings to set up under their jurisdiction and consistency between such national regimes leading potentially to a common EU passport is desirable,

J. whereas some hedge funds may be directly accessible anyway to retail investors via

[1] OJ C269, 16.10.1995, p.194.

European market listings or third country jurisdictions or indirectly via funds of funds or structured notes,

K. whereas success in attracting SAIVs onshore depends on establishing a lighter regulatory regime than for conventional UCITS and that any such regime should concentrate on provision of sufficient and intelligible information to the investor rather than on over-prescriptive rules and regulations,

L. whereas there is a need to inform less sophisticated investors about the various styles and risks of this type of investment and, in particular, to make them fully aware that this type of investment should be clearly differentiated from conventional UCITS,

M. whereas funds of funds provide diversified entry to the sector, but in due course direct investment into the underlying funds should be permissible also,

N. whereas there is risk of systemic damage to the global financial system if these forms of investment proliferate without quantification or control,

Concerning derivatives

O. whereas recommendations were already formulated in 2001 by the Financial Stability Forum concerning the need for transparency in connection with, and regulation of, hedge funds and the need for financial regulation in offshore centres, and whereas implementation of these recommendations in the Member States has been uneven, but, overall, inadequate,

P. whereas with the near completion of the Financial Services Action Plan it is appropriate for the Commission to turn its attention to what would be a suitable legislative accommodation for hedge funds and other sophisticated alternative investment vehicles which currently have no European regulatory home,

Q. whereas derivatives are increasingly used in investment products available to the general public and are therefore becoming a relevant consideration in all the directives cited above,

R. whereas, over the last 20 years, derivatives have played a vital role in financial innovation, facilitating the creation of a range of new products (including many low risk products) and widening investor choice,

S. whereas derivatives can be a means of limiting risk as well as of speculative risk-taking and can provide a macroeconomic benefit by dispersing risk to those best able to accept it,

T. whereas, commodity derivatives can play a vital role in hedging risk and ensuring efficient utilisation of resources in markets such as energy and agriculture, whereas their importance can be expected to increase with further liberalisation of energy and agriculture markets,

U. whereas it is imperative that such risk be properly monitored and controlled both as regards the risk to individuals and systemic risk to the financial system,

V. whereas it is important to ensure that the regulation of derivatives is proportionate to the risks they pose for individual investors and for overall financial stability and whereas it is vital that a wide ranging and effective cost-benefit analysis is carried out before any new laws or rules are added to existing regulation of these financial products,

W. whereas the proliferation of credit derivatives raises issues in terms of tracking global levels of risk exposure,

X. whereas those OTC ("over-the-counter") derivatives which are unregulated could build up into a dangerous overhang in financial markets,

Y. whereas the validity of derivatives depends on the certainty of full settlement at maturity and therefore on the credit standing and ability of ultimate counterparties to meet obligations,

Z. whereas sophisticated types of derivatives may be illiquid and therefore holders may have difficulties closing or valuing positions, especially in difficult market conditions,

Aa. whereas derivatives are becoming a common mechanism in the financial management of corporations, investment companies and smaller banks and it is necessary for those users to have appropriate competence in controlling risk exposure,

Ab. whereas knowledge and competence even among regulatory authorities is often inadequate in this fast moving and ever changing area,

Ac. whereas financial derivatives can be marketed to retail investors in various forms, such as listed products and spread betting, provided they are under the scope of national financial regulators,

<u>*Concerning hedge funds*</u>

1. Reminds the Commission that pursuant to Final Article 2 of Directive 2001/108/EC it is requested to prepare a comprehensive report on this area of investment practice by 13 February 2005 and suggests that this should be brought forward much sooner, given the potential for systemic risk as well as the increased interest in the general investor community;

2. Calls on the European Commission to introduce –given the fact that many hedge funds operate offshore and are not subject to EU regulation – EU legislation in order to make the lending by EU financial institutions to offshore hedge funds more transparent;3. Feels it is opportune to facilitate access to SAIVs for the moderately affluent investor and, in due course, the retail investor and that regulated funds of hedge funds could play a valid role in this gradual process;

4. Considers it timely to develop a light handed and appropriate EU-wide regulatory regime for SAIVs which will help to attract them to locate in the EU and provide the benefits of a common European passport by means of mutual recognition;

5. Points out that a regulatory regime for SAIVs must be sufficiently light-handed so as not to negate their role as an alternative investment medium of choice or impede the freedom of investment managers (inter alia) to:

   - employ innovative and even exotic techniques and instruments,

   - take strong positions, including by the use of shorting, leverage and derivatives,

   - be remunerated relative to their performance,

   provided that their investment and operating methods are disclosed in appropriate terms to those who invest with them directly or indirectly;

6. Considers that the regulator must verify and be satisfied that the promoters, directors and managers of a SAIV are fit and proper persons to be entrusted with responsibility for the savings and investment funds of third parties and are adequately expert and well-informed in the investment techniques and instruments employed in that undertaking, that the risks inherent in any SAIV are clearly advertised and communicated to investors, that the advertised style of investment and level of risk are not exceeded and that risk is properly monitored and controlled;

7. Stresses that the SAIVs regime should concentrate most particularly on the distribution and sales methods employed, so as to avoid investment in them by persons for whom they are inappropriate;

8. Considers that investment funds should be able to elect to be regulated under the UCITS or the SAIVs regime and be bound by that regime's requirements;

9. Urges the investment industry and national regulators to sponsor campaigns to educate potential investors about SAIVs, their characteristics and their risks;

10. Considers it most desirable that distributors should be specifically authorised to distribute SAIVs and that such authorisation should depend on their probity and level of knowledge regarding SAIV products and be renewable on a regular schedule;

11. Considers it essential to provide individuals investing in SAIVs with a clear and simple risk description and warning to be acknowledged by them as representing their understanding of the risks involved;

12. Encourages the industry to develop a self-regulatory code of conduct that encompasses aspects not expressly covered in the light-handed formal regime and in particular regarding appropriate sales and distribution methods;

13. Accepts that a minimum limit might be imposed on investments into such funds while public understanding is poor but that this should be progressively reduced and ultimately eliminated as awareness improves;

14. Suggests that it should be permitted for SAIVs which have long term investment horizons to restrict the periodicity of windows for sales, redemptions, dealings and net asset valuations;

15. Considers that SAIVs should be required to run rigorous daily risk controls so as to ensure that they stay within their advertised risk parameters;

16. Urges the regulatory authorities**,** following consultation with the industry, to develop easily understood and consistent risk measurements or indices, which should be published regularly to indicate to investors that advertised risk limits are being observed;

17. Urges that an EU regulatory regime for SAIVs come within the Lamfalussy Process and that the detailed requirements be decided and regularly reviewed at level 2 but subject to Parliamentary scrutiny and call back;

18. Calls on the Commission to consider whether a regime for SAIVs should be enacted as a distinct part of a revised UCITS directive or in a separate directive and considers that any such regime should cover hedge funds and other alternative investment funds;

19. Considers that the world's supervisory authorities should develop an effective means**,** possibly including a centralised credit register at the Bank for International Settlements as proposed by the Financial Stability Forum of April 2000, to monitor and control the extent of credit, management and operational risk which this sector could bring to the world's financial system and urges the Commission to instigate such a mechanism, which should also include the more effective enforcement of existing provisions;

20. Calls on the Commission in conjunction with national regulators to investigate the practice (predominantly by American arbitrage hedge funds) to use time zone differences and the influence of Wall Street on other markets to profit by market timing Asian and European mutual funds, to determine whether this significantly harms long-term investors in those funds and whether any steps need to be taken to rectify the situation;

21. Expects the Commission to report on fiscal and regulatory differences between the Member States, pointing out both fiscal and regulatory dumping measures and measures that discriminate against SAIVs domiciled in other Member States;

22. Urges the Commission to consult with the legislative and regulatory authorities in the USA, Japan, Switzerland and other relevant jurisdictions with the aim of developing as consistent an approach as possible internationally in this area of investment and to report on the implementation in the different Member States and in third countries of the recommendations of the Financial Stability Forum in particular as regards hedge funds and the regulation of offshore centres, and to indicate what steps it intends to take with a view to the introduction of essential regulations at the international level;

Concerning derivatives

23. Stresses that derivatives are a completely different area, and therefore need to be subject to different regulations than hedge funds;

24. Calls on the Commission to present the reports asked for in the above mentioned resolution of the Parliament of 22 September 1995on Financial derivatives: their present role on capital markets, their advantages and risks;

25. Calls on the Commission to pay particular attention to derivatives when drafting new or amended directives concerned with financial services and also at the implementing stage

under the Lamfalussy Process; stresses that such financial instruments, whilst useful, are also high risk, and can increase volatility and threaten financial stability;

26. Calls on the Commission in the interests of coherence in securities law to draw together the various relevant items of EU legislation in order to facilitate comprehensive legislative treatment (inter alia) of derivatives;

27. Calls on the Commission to instigate, along with national and relevant international institutions, a means of measuring and monitoring global exposure in derivatives and, in particular, the accumulated credit risk (including settlement risk) of credit derivatives; stresses that only those with high capital cover may deal in derivatives, in order that, in periods of crisis, losses do not have to be borne by taxpayers, as has happened during the various crises, including in the case of the LTCM crisis;

28. Recognises that significant regulation and regulatory structures already exist to cover derivatives. Notes the importance of ensuring that reporting requirements have adequate product coverage and of ensuring all relevant regulators have the resources and expertise to assess this data effectively;

29. Notes the legal uncertainty which makes the use of derivatives in some Member States very difficult and urges policy-makers to come up with a solution to this problem;

30. Asks the Commission to consider whether further steps need to be taken in the context of Basel II to provide adequate reserves in the banking system and in individual banks to meet any likely demands on liquidity by exposure to derivatives;

31. Asks the Commission to further consider whether, in the context of Basel II, the off-loading of credit risks by banks to non-banks should allow a reduction in capital requirements and, if so, how the exposure in non-banks (including in particular in hedge funds) might be assessed, monitored and controlled;

32. Urges accountancy and investment management associations to require a high level of understanding of derivatives, their mechanisms and risks, as part of their qualification criteria;

33. Asks the Commission to continue working with the International Accounting Standards Board and other like bodies to develop as soon as possible conventions regarding the definition, quantification and accounting of derivatives and derivative positions in company accounts;

34. Urges that derivatives exposure (including timing gaps), which give a fair and consistent indication of a company's true condition, should be a required disclosure in the accounts of European companies;

35. Considers that derivative valuations should take into account, by way of contingency reserve, the additional risks which could pertain in difficult market conditions and relative to the credit standing of counterparties;

36. Requires the European Commission and Member States, via the Lamfalussy Process, to co-ordinate their approach to derivatives that are offered on European markets whilst respecting the need to maintain flexibility for different derivative products and markets;
37. Calls on the Commission to ensure that European derivatives exchanges should have fair and equal access to foreign market places and considers that recent protectionist moves by American competitors are unacceptable;

38. Instructs its President to forward this resolution to the Council, the Accession State Governments, the Commission, the regulatory authorities in all Member and Accession States, the European Economic Area and the Governments of Switzerland, Japan and the USA and the International Accounting Standards Board;

EXPLANATORY STATEMENT

Hedge Funds

A W Jones established the first hedge fund in 1949. He combined two risky types of investment - short selling and leverage - to limit overall exposure to market risk. The fund was therefore "hedged" because he combined holding stocks, purchased with borrowed money, that would gain if the market went up, and short positions, that would benefit if the market went down. He also made the manager's fee a percentage of the profits (20% in his case) and committed his own investment capital in the fund.

Assets under management now are estimated to be between US$450bn and US$600bn. The number of hedge funds managed in Europe in 2001 were 446[1] but this represented only 15% of the global total of hedge fund assets.[2]

The US *President's Working Group on Financial Markets* in 1999 defined a hedge fund as "***any pooled investment vehicle that is privately organised, administered by professional investment managers, and not widely available to the public***". The UK's Financial Services Authority has declined to define the term because there is no identifiable commonality.

However, some common characteristics usually are:
- private partnerships or investment corporations;
- offshore, usually in low tax and low regulatory regime havens;
- performance related fees;
- freedom to use a variety of investment techniques to enhance returns and/or to reduce risk;
- limited to rich and sophisticated investors;
- aim for absolute returns.

Trading strategies are often based on mathematical models, market inefficiencies or economic trends. Primary investment categories identified are (Tremont/TASS):

Long/Short equity	Investing on the long and short side of the market so as not to be market neutral.
Convertible arbitrage	Taking a long position on a convertible security and a short position on its common stock.
Event driven	Profit from a corporate event (e.g. a merger).
Equity Market neutral	Exploit inefficiencies in the equity market and minimise market risk.
Global Macro	Profit from major economic trends or events.
Fixed Income Arbitrage	Profit from arbitrage opportunities in fixed interest rate securities.
Dedicated Short Bias	Invest mainly in short positions in equities and equity derivative products.
Emerging Markets	Exploit inefficiencies and poor information in immature markets.
Managed Futures	Trade in listed financial and commodity futures markets.

[1] Data from the Financial Services Authority's discussion paper on hedge funds (August 2002).
[2] Data from PricewaterhouseCoopers (May 2003).

Funds of Funds Invest in multiple hedge funds with different investment styles.

Hedge funds do not need to meet any "official" dispersion risk ratio. Their recent strong growth is due to good positive returns in a period of poor performance by the main indices and to resulting demands by investors to diversify portfolios.

Investors have usually been "qualified" individuals, who understand and accept the inherent risks. Hedge funds have made themselves difficult to access by any but appropriate investors. However, there have been many new entrants in the last 2-3 years, including small outfits run by former long-only asset managers.

Pension funds and insurance companies are now becoming significant participants. The UCITS Directives permit funds of funds to invest up to 30% of their assets in “other collective investment undertakings”, including hedge funds, so long as they meet standards equivalent to the relevant directives[1]. With media coverage, interest from retail investors has also been aroused.

Hedge funds are subject to legislation in the jurisdiction in which they are domiciled. This may be confined to aspects such as fraud, money laundering and market manipulation. Managers are often located in a different and more strictly regulated jurisdiction, but are only subject to regulation of their managerial functions by that jurisdiction. There is no single global approach by regulators and in several EU Member States legislative changes are currently in process.

There has recently been growth in the number of funds of funds authorised in Europe. Switzerland, Luxembourg, Italy, Ireland and Hong Kong have eased regulations to make them more accessible to mainstream investors[2]. The German legislature is currently considering proposals for regulation. The UK recently decided not to relax its regulations.

Ireland has perhaps been the most active in broadening access to hedge funds. Previously retail investors could only access funds of funds that invested less than 10% of net assets in unregulated funds. The Central Bank of Ireland changed this in December 2002 to allow registered funds of funds to invest entirely in unregulated schemes provided that there is a minimum investment of €12,500, the fund manager has appropriate expertise and the fund does not invest in other funds of funds.

In the USA concern about hedge funds has prompted a report by the staff of the Securities and Exchange Commission which recommends more explicit means of regulation and registration of participants.

If retail investors are going to invest more in hedge funds, it would be preferable for them to be domiciled in Europe where there could be better supervision. Tax regimes and the lack of a single regulatory market are a deterrent with many Member States imposing tax penalties on investors who invest in a foreign domiciled hedge fund.

[1] Directives 2001/107/EC and 2001/108/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC.
[2] Financial Times, July 31, 2003, Thursday USA Edition 2.

Derivatives

Derivatives can be applied either to reducing or increasing exposure to risk. They were used in Ancient Greece by olive growers who would agree delivery at a price and time in the future in order to reduce the risk of prices being lower at harvest time.

They encompass many products and new ones are being created all the time. There has been particularly rapid growth in the futures, options and swaps[1] markets. Interest rate and currency derivatives outstanding[2] at the end of June 2003 were $123.9 trillion, credit derivatives $2.7 trillion and equity derivatives $2.8 trillion[3].

Performance is linked to an underlying "asset" or mathematically measurable item (equity, rate of interest, currency, commodity (including energy), index, volatility) and are normally settled at a future date.

The main derivative retail markets in Europe are in covered warrants, certificates, reverse convertible bonds ("cash market products") and, in some countries, "organised markets". A more extreme version is spread betting. This facility to "bet" on movements in financial instruments can provide a means of "hedging" or speculative position-taking. In the UK this is regulated by the FSA along with conventional financial services.

Derivatives have been taken into account in a number of recent directives. Derivative products can be sold to retail investors in Europe[4], provided a prospectus explains how the derivative works and a risk profile is included. All countries emphasise the investment firm's responsibility to assess the customer's ability to deal with such products. Regulators may refuse approval of a derivative product if they consider that it is not clearly understandable.

The proposed Investment Services Directive imposes rules of conduct on firms offering investments in derivatives products. The Market Abuse Directive includes derivative markets which were not covered by previous legislation. The UCITS and accounting directives have also been extended to cover financial derivatives. The current review of capital adequacy rules (i.e. CAD III) should further improve the prudential framework, in line with the Basel II accord, and will also cover the operational risk embedded in such activities.

Areas of debate

1. The market place for hedge funds is fragmented due to varying regulatory regimes, the lack of consistent platforms and discriminatory tax regimes. Institutional and private investors are showing increasing interest, but lack suitable vehicles in EU jurisdictions. Your rapporteur feels that a separate lightly regulated regime would be the best option. Funds would elect to be regulated under this regime and would be required to stand by its particular rules.

---

[1] Interest rate swap: an agreement between banks or companies to exchange interest payments (usually fixed-rate versus floating-rate).
[2] The "outstanding or notional amount" is simply a quantity used to calculate payments. Typically it does not change hands;
[3] International Swaps and Derivatives Association.
[4] According to the Prospectus Directive 2003, derivatives will benefit from the European passport.

2. There is concern about allowing hedge funds to be sold to retail investors without clear disclosure of trading strategies, performance fees, performance reporting, financial transparency and certainty of pricing. It is clear that such products must have a very clear and well understood health warning as well as a foolproof description of their style and risk profiles, including their fee structures.

3. With derivatives, regulators are beginning to consider whether adequate information on the underlying asset is available, whether the retail investor is aware how the product may react to market change, whether the price of the product is correctly constructed and whether publicity is adapted to retail investors. Education and clear information must be the key to equipping investors of all types with the ability to understand the risks inherent in such products. Advisers, investment managers, credit officers and accountants should be tested on them in their qualifying exams.

4. There is concern about the systemic impact which derivatives and hedge funds might have on financial markets via market risk, operational risk and credit risk. Regulators and banking supervisors should develop means of assessing and interchanging with each other the extent of any such accumulated systemic risks.

5. Hedge funds and derivatives can be high risk if there is inadequate internal risk control. Less habitual participants, such as corporates and individuals, may be less able to deal with them, with risk of unforeseen and unsustainable losses. The accounting regulators should be implementing, in the context of internationally accepted accounting standards (e.g. the International Accounting Standards Board) and internal audit controls, a required reporting system for all company accounts. For individuals, the only recourse can be to education and some degree of protective regulation related to the extent of knowledge, wealth and sophistication.

6. Banks have established internal limits for credit risk (based on their own criteria and/or rating approach), even if credit derivatives may distort or exaggerate these assessments. The Basle II Committee will include specific requirements for this type of risk. The EU will need to be attentive to this particular category of risk in its transposition of Basle II.

7. Regulators may have difficulty assessing risk and keeping up with fast developments. They may not always be aware of the exposure of the international financial system as a whole. For the time being we would tend to favour co-ordination of national regulators rather than an EU regulator. They will require to have adequately expert staff in order to fulfil this quite exacting role in a fast-moving and technically shifting area of finance.

8. It is argued that derivatives and hedge funds contributed to recent market volatility. Others claim they add stability to markets. On balance your rapporteur feels that hedge funds and derivatives contribute to the efficiency and self-balancing of financial markets and a light-touch regulatory regime in a free-flowing global market with near-harmonised basic rules would be the best option.