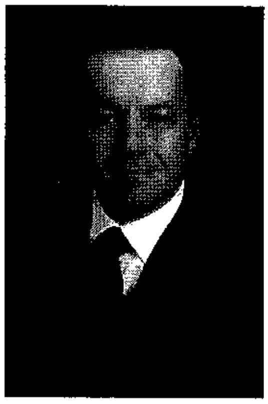
Frank Dornseifer



Frank Dornseifer is Managing Director Legal and Policy Affairs of Bundesverband Alternative Investments e.V. He studied law at the universities of Bonn, Dublin (Trinity College) and Lausanne. After admission to the German bar in 2000 he practised various years as attorney in an international law firm in the field of corporate and securities law before joining the German Financial Regulator BaFin as deputy head of the policy unit within the investment management department. In this function he also represented BaFin in the Investment Management Committee of IOSCO, which elaborated in this time various reports on (fund of) hedge funds. Mr. Dornseifer frequently publishes articles both on investment and corporate law and he is editor of the compendium „Corporate Business Forms in Europe“. The finance committee of the German Bundestag, the EU commission and the European Parliament denominated him several times as authorized expert on capital market law. Mr. Dornseifer gives frequently speeches at national and international conferences on investment and regulatory topics.

Bundesverband Alternative Investments e.V. BAI

Why are Hedge Funds under the light?

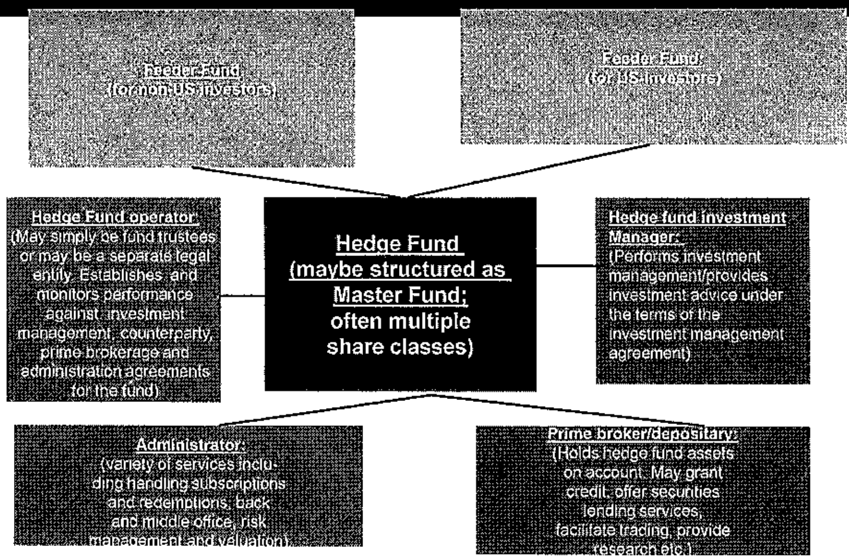
Frank Dornseifer, Attorney-at-law
Managing Director Legal and Policy Affairs, BAI

IOSCO seminar training „new financial products“
Kuala Lumpur, November 29, 2011

- What are Hedge Funds?
- What risks do they pose? How do Hedge Funds serve investor expectations?
- What are regulatory concerns for the industry?
- How do Hedge Funds serve investor expectations?
- Access to Hedge Funds for different types of investors

- **Attempt to define a hedge fund**
  - **IOSCO says "it is impossible"**
  - **In practice only an investment/mutual fund with almost no investment limits?**

- **Typical hedge fund characteristics**
  - Employment of techniques like short selling, derivatives for investment purposes, economic (debt) leverage as well as leverage embedded in financial instruments such as derivatives.
  - pursuit of absolute returns, rather than measuring their investment performance relative to a benchmark;
  - charging performance-based fees in addition to a management fee based solely on assets under management;
  - broader mandates than traditional funds which give managers more flexibility to shift strategy;
  - high trading volumes/fund turnover; and
  - frequently setting a very high minimum investment limit (e.g. US $100,000 or higher for most funds).



- Direct investment
  - Single hedge fund (offshore/onshore)
  - Fund of Hedge Funds
  - Alternative UCITS Fund
  - Managed account
    - Single Investor Fund
    - Segregated Managed Account (own account/third party platform)
- Indirect investment
  - structured products (with or without capital guarantee): earnings, repayment, market price or value of which are linked to hedge funds and by means of other forms of investment issued by companies such as shares or profit participation rights of companies which for their part invest primarily in hedge funds

Factors in choosing domicile

- Onshore vs. Offshore
- Location of investors
- Regulation
- Service providers
- Market perception

- Fund domicile:
  - 60% registered in offshore locations
    - Cayman Islands 37%
    - Delaware 27%
    - BVI 7%
    - Bermuda 5%
  - 5% registered in the EU – primarily in Ireland and Luxembourg

- Location of management
  - 68% North America
  - 22% Europe
  - 6% Asia
  - 4% Other

(Source: TheCityUK, Hedge Funds, Financial Markets Series, May 2011)

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- Offshore funds facilitate pooling of capital from different jurisdictions
- Funds taxed in accordance with law of countries where the funds are invested
- Investors taxed when funds received
- Offshore centres serve as tax-neutral conduits – eliminating third layer of tax
- Widely used in pension planning/pooling
- Top quartile governance ratings, rank very highly in anti-money laundering and anti-terrorist financing evaluations of the FATF
- Participants in Global Forum on Transparency and Exchange of Information
- Meet OECD's internationally-agreed standard on information exchange
- Tax Information Exchange Agreements being entered into (unilateral and bi-lateral)
- MOUs entered into between Regulators

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Equity Long / Short strategies

Equity long/short managers look to profit from strong stock selection – either investing in companies that are likely to outperform or selling short those that are considered overvalued. Managers are usually able to adjust market exposure and enjoy a high degree of flexibility as markets change. Managers can choose net-long or net-short market exposure (positive beta or negative beta).

Equity Market Neutral strategies

A market neutral strategy uses the combination of buys and short-sales (sometimes augmented by options and futures positions) to offset any correlation between the portfolio return and the overall market return.

Convertible Arbitrage

Convertible arbitrage strategies consist in taking a long position in the convertible bond and short the company's equity. In doing so, the investor takes advantage of the undervaluation of the convertible bond while reducing the exposure to the underlying stock price movement.

Fixed Income Arbitrage

Fixed income arbitrage strategies attempt to exploit mispricing among fixed income securities. This strategy relies heavily on mathematical models of the term structure of interest rates to identify mispricing and manage positions. There are a number of different techniques that can be identified within the fixed income arbitrage strategy. These techniques encompass among others:

- yield curve arbitrage where the asset manager take offsetting positions at various points of the yield curve ;
- corporate spread arbitrage where the arbitrageur takes long and short positions in two securities based on its anticipation of the evolution of the interest spread between the prices of the corporate bonds and Treasury bills (for example) ;

Global Macro

Global macro investing aims to generate significant returns from movements in equity, currency, interest rate and commodity markets. The strategy is based on managers' use of macroeconomic principles to identify dislocations in asset prices. Macro hedge funds can be classified as either discretionary, where the managers' subjective opinions of market conditions lead them to the trade, or systematic, meaning a quantitative or rule-based approach is taken.

Distressed Securities

Distressed managers invest in securities of companies that are either in default, under bankruptcy protection, or are post restructuring. Bonds and bank debt are the most common types of asset, although, managers may also hold stock, trade claims, private placements and warrants.

Multi-strategy

Multi-strategy funds are usually funds of funds which are invested in funds developing different types of strategies (merger arbitrage, equity/long short etc.).

Managed Futures

Managed futures funds, also known as commodity trading advisors ("CTAs"), use the global futures and options markets as their investment universe to gain exposure to a broad variety of underlying asset classes, including equities, fixed income, currencies and commodities.

CTAs manage their investors' assets using a proprietary trading system, or a discretionary method that aims to capture the trends that occur across markets, irrespective of whether they are bull or bear trends. This involves going long and short futures contracts in areas such as metals (gold, silver), grains (soybeans, corn, wheat), equity indices (S&P futures, Dow futures, NASDAQ 100 futures), soft commodities (cotton, cocoa, coffee, sugar) as well as foreign currency and government bond futures.

Take-over/ merger arbitrage

Merger arbitrage managers try to exploit the movements in the stock price of companies undergoing mergers. Due to the various risks associated with the merger deal not closing in the specified time frame or indeed, at all, this strategy is also known as risk arbitrage.

Volatility arbitrage

Volatility arbitrage is a type of statistical arbitrage that is implemented by trading a delta neutral portfolio of an option and its underlying assets. The objective is to take advantage of differences between the implied volatility of the option, and a forecast of future realized volatility of the option's underlying assets.

- **Are there specific risks related to Hedge Funds or are these risks related to a number of market participants?**
  - **Market risk (Amaranth) -> market illiquidity**
  - **Risks for the banking sector (as creditor/investor) –> systemic risks through collapse of (a) hedge fund(s) (LTCM)**
  - **Leverage risk (investment losses)**
  - **Herding (amplification of market movements)**
  - **Market disruption (in case of failure or significant distress of a large and highly exposed hedge fund or a cluster of medium-sized hedge funds)**
  - **Positive feedback trading**

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but:

- „The recent financial crisis is not actually a hedge fund crisis." (IOSCO)
- „Hedge funds are not actually ‚unregulated' in the strict sense of the word in many jurisdictions." (IOSCO)
- „AIFM were not the cause of the crisis, recent events have placed severe stress on the sector. The risks associated with their activities .... may in some cases have contributed to market turbulence." (EU-Commission)
- „Private equity funds, due to their investment strategies and a different use of leverage than hedge funds, did not contribute to increase macro-prudential risks." (EU-Commission)

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[redacted]

- **Completion of markets:**
  - Diversification (Adding hedge funds to an investment portfolio provides diversification not otherwise available in traditional investing)
  - Enhancing of risk allocation (by risk taking from banks and insurance companies)
  - Low correlation with overall market trends
- **Enhancing efficiency of financial markets**
  - Optimize risk return profile (Inclusion of hedge funds in a balanced portfolio reduces overall portfolio risk and volatility and increases returns)
  - enhancing market liquidity and market efficiency
  - Short selling as an instrument to avoid price bubbles
  - Reduction of volatility
  - negative feeedback trading (stabilizing effeects in declining markets)

[redacted]

- Regulation of the Fund and /or regulation of the manager
- Balancing effectiveness and efficiency in regulatory oversight
- Cost of regulatory compliance
- Meeting investor demands - performance, transparency, liquidity
- Marketing issues (AIFMD, removal of national private placement regimes?)
- Depositary issues (AIFMD; eligibility and liability)
- Remuneration requirements (AIFMD)
- Third country and passporting issues (AIFMD; barriers to enter the EU market, barriers for EU investors to invest outside the EU)

[redacted]

- Overview
  - Legislative restrictions to invest in hedge funds:
    - AIFMD: marketing only to professional investors (MiFID definition), marketing to retails investors subject to national law
    - Europe: specific restrictions for insurance companies and occupational pension systems (Solvency II)
  - Fund restrictions to invest in hedge funds: frequently setting a very high minimum investment limit (e.g. US $100,000 or higher for most funds).
- Investor responsibilities and investor freedom:
  - who is a "sophisticated" investor?
  - is net worth an appropriate standard?

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[redacted]

- Regulation of Hedge Funds is mandatory, however,
  - so far there is no global level playing field,
  - regulation must be proportionate and must not patronize (professional) investors.
- Investors require alternative investment opportunities. Diversification is more important than ever. Especially in the current market situation traditional asset management might not be able meet these requirements.
- Current market situation as well as approaching regulation are a significant challenge both for investors and the asset management industry itself.

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[redacted]

- www.absolutereturn-alpha.com
- www.aima.org
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- www.mfainfo.org

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- 1997: Founded in Bonn as „Bundesverband Derivate"
- 2000: Renaming in Bundesverband Alternative Investments e.V. (BAI). Focus on Hedge Funds, Private Equity, Commodities, Infrastructure and other Alternative Investments
- Since 2000: BAI as central lobby association of the AI industry in Germany and catalyzer between professionellen German investors and excellent providers for Alternative Investment products.
- Number of member undertakings as of September 2011: 128
- More information available under www.bvai.de

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- Higher the level of awareness and deepen the public understanding of alternative investment strategies
- actively conduct legal reforms to build up an attractive and competitive regulatory environment for the alternative investment industry and their investors in Germany
- Dialogue with the relevant institutions in the financial sector (i.a. Ministry of Finance (BMF), Federal financial supervisory authority (BaFin), EU Commission, ESMA and other industry associations)
- Establishment of plattforms for the dialogue between industry and investors
- Counteract abusive and untrustworthy market practice

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