Report on Wilton Park Conference WP830

CAPITAL FLOWS AND THE SAFETY OF MARKETS

Friday 10 – Saturday 11 November 2006

SAFETY OF MARKETS

1. The first question tackled by the Conference concerned the safety of the global financial sector. Participants concurred on the definition of a stable financial system as one that would efficiently direct capital to its most productive uses, ensure that risks are borne by able and willing market participants, provide frictionless payments and securities transactions and accomplish these tasks under good economic conditions as well as during times of stress or structural change. The Conference addressed two questions: (a) do we have the right tools to measure the risks generated by our markets, and (b) do we have the right regulatory instruments to correct possible imbalances?

It was noted that a number of developments over the past few years have increased the weight and the complexity of the financial sector in the economy. The most important change was the enormous growth in financial transactions.[i] Against this background of a larger, more complex and inter-connected financial sector, the Conference discussed the major risks faced by the global financial system arising from the macroeconomic environment as well as the structure of the financial markets.

First of all, **the potential correction of global macroeconomic imbalances**, such as the US current account deficit, could lead to a slowdown in global economic growth, with worldwide spillover effects. On the other hand, the continued growth of the US current account deficit was identified as the source of potential turbulence in

the foreign exchange markets through the effect of rising US interest rates and a falling dollar, with a significant impact on emerging markets, particularly certain Asian or oil-exporting countries, which strongly depend on the US dollar, or Eastern European countries with high current account deficits and a large share of foreign-denominated debt. Falling prices in the US real estate market were seen as another risk, as were disruptions in the oil market that could emerge as the result of continued increase in global demand, primarily spurred by rising energy consumption in emerging markets not being met by limited reserves and refinery capacities. A downturn in the macroeconomic conditions was seen as significant since the financial sector contained risks which appeared to be contained for the time being, thanks to the favourable macroeconomic environment. In the event of an economic slowdown, major corrections could take place in the financial markets.

The **primary risk factors** in the financial markets were seen as:

(a) **The possible mispricing of assets in the search for higher yields**, which, in the presence of ample liquidity, have led to an interest in higher risk products and possibly less robust counterparties;

(b) **Very low spreads in the corporate loan and credit risk transfer markets,** reinforced by the use of similar risk management systems and models by market participants, which would lead to liquidity problems and crowded trades in the event of a disturbance in the market or changing views;

(c) **Complex financial instruments** (particularly the fast-growing market for credit risk transfer, where credit risk is separated from the underlying credit relationship and becomes tradable), which made risk management difficult due to the complexity of the valuation of the products. The risks were being exacerbated by the lack of transparency on where credit risks are eventually shifted due to serious backlogs (despite recent improvements) in the confirmation and settlement of trades, the concentration of the trades in a small number of counterparties, and the concern that such products may be offered to a wider range of investors unable to assess their risks properly;

(d) **The considerable market share of investors with a short-term focus**, such as hedge funds[ii] with highly leveraged positions, which could move out of the markets very quickly and thus cause disruptions and high volatility;

(e) **The large number of leveraged buy-outs**, which posed challenges to the risk management of the creditors involved because of the increasing reliance on debt financing, which forced up the liabilities in the books of the takeover target and negatively affected its credit quality and thus increased credit risk;

(f) **Large, complex financial institutions,** which played an important role in the international financial system as counterparties and as providers of liquidity, and which seemed to increase the risks they took as measured by, for example, the value at risk, and which were increasingly more dependent on volatile sources of earning such as investment banking and proprietary trading;

(g) **The increasing importance of business with hedge funds or private equity funds**, which had been associated with, for example, very low initial margins due to competition among prime brokers, and which could turn out to be problematic for the banks in stress situations; and

(h) **The increasing shift of activities into unregulated or insufficiently regulated countries or market segments,** raising concerns about the adequacy of cross-border information exchange, supervisory cooperation and transparency on activities despite significant recent improvements.

From the institutional investors' perspective, all of the methods sought in the search for higher yields (private equity, short selling strategies, complex instruments, leveraged buy-outs and combinations thereof) were acceptable, but only so far as they were driven by proper incentives and subject to adequate risk assessments. As an example, the rise in private equity presented a complex picture. On the one hand, private equity played a useful role because it could take a longer term view than public capital. On the other hand, in certain cases the shift from public capital to private equity was symptomatic of a disproportionate burden on public companies (such as accounting or financial disclosure rules), with the resulting paradox that policies aimed at transparency might reduce transparency.

Participants discussed ways of addressing these risks. Market discipline was seen as the first line of defence against these risks, but its effectiveness rested upon the availability of sufficient information and the use of adequate risk management systems. The boards of directors of banks needed to overcome the extreme financial motivation and technicality associated with the products dealt with in the sector to fully assess the overall risks taken by the banks. Public authorities had an important

role to play by supporting private sector initiatives for disclosure and better management of risks, encouraging instruments such as codes of conduct, and setting in place an institutional and legal framework that gives market participants the right incentives and provides effective supervision. Finally, in the Eurozone area, the effect of a major bank crisis, one that may be precipitated by a failure in private equity, remained to be tested.

To strengthen the safety of markets, transparency needs to be improved in a way that facilitates risk assessments and strengthens market discipline, in particular through the availability of comprehensive information in the following areas:

- hedge funds' activities (with due recognition of the fact that this has to be balanced with hedge funds' need to keep their strategies secret);
- the transfer of credit risks;
- data on transaction volumes in financial products that are traded over-the-counter (OTC), such as credit derivatives, or capital flows through newer centres.

In this context, industry-led recommendations, such as the Counterparty Risk Management Policy Group (CRMPG) Report, which dealt with financial institutions' relationships with risky counterparties, and the recent substantial reduction of confirmation backlogs and the increased automation of trade processing for credit derivatives were both noted as positive examples of efforts to improve market practices and to develop best practices that can reduce risks.

RISKS IN THE COMMODITIES MARKETS

2. The commodities markets offer new opportunities in terms of investment. However, these markets are quite specialised, and, reflecting their traditionally institutional investor base, less regulated. Participants debated whether the global markets had the right tools to measure the exposure of the various actors in this field and whether the players were aware of the types of risks they are exposed to.

Today's commodity markets are driven by **several factors**, including: very strong demand from emerging markets, in particular but not only China; fund, including hedge fund, participation; and the legacy issue of under-investment. Hedge funds play a positive role as providers of liquidity and facilitators of risk.

The fact that prices of on-exchange metals are near record highs (though not in inflation-adjusted terms) is not seen as a source of risk; what matters in these markets is whether the price levels are credible, i.e. whether the validity of the current prices is underpinned by the market fundamentals. By this standard the price levels are valid since comparative analysis of price volatility shows that prices reflect the influence of fundamentals rather than price speculative activity by investors. This view is supported by a recent IMF study, which concluded that, while investors may have played a role in providing liquidity to the markets, there is little evidence that speculative investments have been a significant driver of non-fuel commodity price movements.

Given the drivers of the current price levels, the **main risks** were seen in economic or social stress in China that might disrupt demand and/or the financing of the US current account deficit; alleged currency manipulation; and possible economic nationalism that might close off markets. Other risks lay in the fragmentation of existing markets, which could result from the 'traditional' users being frozen out, the loss of price credibility and liquidity, or a major default.

There was considerable risk related to OTC and physical markets which was not the object of any concerted monitoring. Participants discussed the possible convergence of exchange-traded and OTC markets, and heard about recent efforts to capture OTC and physical market risk in exchange-traded and/or cleared products. By providing a price signal and helping dissipate the risks in a case of crisis, exchanges fulfilled the dual tasks of crisis prevention as well as crisis management. Exchange trading involved constant monitoring of members and their clients and guidelines on lending requirements as safeguards. On the other hand, bringing these products on-exchange was not easy due to contract specifications, the number of counterparties, and low transaction liquidity despite large volumes and values. The lack of transparency in OTC markets was a source of profitability which generated a resistance to change. Converting these products to exchange products would also require expansion of clearing capacity. The solution lay with ensuring that clearing was robust, innovative and secure.

Participants also discussed the characteristics of **energy markets**, which bore certain similarities to other derivative markets (in terms of sources of price risk) but were also different (e.g. physical infrastructure in energy markets was a key source

of volatility). The short-term physical and the long-term derivative parts of the market were inter-linked. These markets faced risks related to the low disclosure on old long-term supply contracts and the change in the nature of the markets (the entry of new players affecting the supply/demand balance). However, an important empirical observation was that the failure of very significant players over the last five years had not posed any systemic risk. Finally, market squeeze was seen as more likely in a local market; it was made more difficult by the availability of adequate storage and transportation.

BOND MARKETS

3. The European bond markets have undergone exponential growth with the introduction of the Euro and the entry of more corporate issuers. Participants sought to identify the challenges posed by this **very rapid growth**, combined with **increasingly more complex products.** This trend was amplified by the fact that the credit quality of issuers – previously limited mainly to high-quality, large issuers or retail-oriented "household names" – was diversifying. The growth of the high yield markets has been remarkable, even though it started from a very low base. The current trend of leveraged buy-outs, as well as mergers and acquisitions, may also have a substantial impact on the bond market. Finally, the decisions by some issuers to sell or buy significant assets on a more frequent basis, especially among investment grade corporations and banks, is a potential concern, as their debt instruments have traditionally contained little in the way of protection for investors.

On the positive side, it was noted that primary market documentation and credit research have improved over the last few years, strengthening **market discipline**. There was also agreement that the degree of competition is high. The effect of EU legislation, such as the Prospectus Directive and the Transparency Obligations Directive, was generally seen as positive in raising statutory disclosure standards and unifying the regulatory framework to allow issuers the chance to raise capital across the EU. The impact on 3rd country issuers was more mixed, due to the uncertainties associated with the application of disclosure obligations, especially the International Financial Reporting Standards equivalence requirement, to these issuers. It was also noted that the strengthening of the EU rules had contributed to the emergence of unregulated markets and markets not subject to EU laws. It was particularly noteworthy that the Prospectus Directive had had the unintended effect of

raising the average denomination of debt issuance due to the 50,000 Euro threshold used for the lighter wholesale securities regime.

Participants also discussed the transparency of the **secondary bond markets** and whether pre- and/or post-trade transparency of prices and volumes on secondary markets, currently under discussion in the EU, was likely to have a net benefit. Views diverged on the degree of applicability to Europe of the US experience with transparency in general and of the TRACE system in particular. There was common scepticism, however, as to whether greater mandatory transparency would address the perceived insufficiency of investor protection in this area. Many saw stronger reliance on investment advice (to avoid mis-selling such as in the Parmalat case) and best execution as better safeguards of investors' interests than extensive new statutory transparency rules. The low degree of retail participation in many of these markets, the ongoing technological improvements in OTC trading platforms, the relative lack of demand for increased transparency from the buy side, low levels of trading compared to equities and the traditional reliance on self-regulation were seen as factors that justified caution in extending transparency rules designed for equity markets to these markets. There was support for carrying out an experiment on a small scale to test the impact of mandatory transparency rules on the efficiency and transparency of the markets before designing policies on a wider scale.

PRODUCT REGULATION

4. The discussion centred on whether the EU's **UCITS regime**[iii] functioned well and, if not, whether there were any viable alternatives to the product regulation approach underpinning this regime. Participants agreed that the UCITS product had been a success by many measures, raising recognition of the retail collective investment vehicle on an international scale and creating an export potential worldwide. Its use was expected to grow with the increase of private pension schemes. The ensuing debate focused on whether the UCITS product was a sensible way to protect investors, whether it facilitated efficient fund management, and whether the regime addressed new issues emerging, in particular from the rise of listed funds, the exponential growth of new players such as hedge funds (and funds of hedge funds), structured products and sophisticated new fund strategies.

Some participants saw the UCITS product as having served a useful function when the market was at an early stage of development, but considered that mature

markets may derive less benefit from the product regulation approach. There was unanimity on the benefit of the UCITS product with regard to establishing a basis of confidence for retail investors. As the market experience with the product deepened, some saw a strong case for reliance on self-regulation. There was concern in particular about the limitation of product regulation in keeping pace with market innovation and the difficulty of ensuring that regulation could be adapted to the competition among new products that were comparable from the perspective of the investor. There was a general consensus that the co-existence of different regulatory approaches to competing products was not in itself a problem, but that any potential of allowing mis-seling to investors should be minimised. The interaction between the UCITS Directives and the Markets in Financial Instruments Directive (MiFID) was therefore critical.

Many agreed that there was a need to assess the full scope of the regulation, taking into account the regulation of the product, the manager of the fund and the distributing intermediary. Product regulation could be relaxed in light of stricter requirements on the intermediary. In conclusion, the majority of the participants considered that appropriate product regulation (including portfolio construction) can work, and that the problems identified were a question of form rather than principle.

UNBUNDLING

5. Participants discussed the case study of the UKA FSA's work on **soft commission and bundled brokerage arrangements** over the last three years. The work had been initiated by a concern over incentive misalignments between fund managers and their clients due to the opaque nature of the soft commission and bundled brokerage arrangements under which fund managers make direct charges to the funds they manage, by way of commission, to purchase goods and services in addition to execution. In addition, the authority had considered that the lack of transparency and accountability mechanisms in the relationship between brokers and fund managers made it difficult for the customers to judge whether their interests were being well served by the fund manager and consequently weakened market controls. The consultations on the subject demonstrated a broad consensus that fund managers face potential conflicts of interest and support for improving transparency and accountability to customers.

The approach taken by the regulator was principles-based and aimed at stimulating a new market response. The regulator decided that enhanced disclosure could potentially deliver the transparency and accountability outcomes identified, a market-led solution could be the optimal way to deliver the desired outcomes, and the industry should be given an opportunity to deliver it. To ensure the success of the market-led approach, the regulator brought together representatives of the various industry sectors involved and set an agreed timetable for the industry to produce, and test, a disclosure-based model to review.

In parallel, the regulator set out to define the range of goods and services ("execution" and "research") that fund managers can buy with their clients' funds to reduce the scope for abuse. The market was given the task of ensuring that fund management clients would be given clear information about the respective costs of execution and research and the total amount spent by the manager on their behalf, and that fund managers would be encouraged to seek, and brokers to provide, payment and pricing mechanisms that enable individual services to be purchased separately. The regulator planned to take steps to measure the performance of the system in place. The participants agreed on the usefulness of this case study as an example of a market-led initiative being supported by regulatory work to establish the broader framework.

CHANGING ROLE OF SELF-REGULATION AND EXCHANGES

6. Securities exchanges have been going through many changes over the last years, notably in relation to proposed plans of **consolidation and de-mutualisation**. At the same time that the ownership of exchanges has been changing, there have been important market and regulatory developments that transformed the role of exchanges in the global financial systems. Although there is significant diversity across the world in regulatory models, similar questions have been debated over the years concerning conflicts of interest, the relationship between the profit-making models and the regulatory role and the appropriate balance between regulatory and self-regulatory approaches. The limits of **self-regulation** specifically in the context of the regulatory role of exchanges has been debated by IOSCO earlier in the year with the purpose of raising the awareness of IOSCO members regarding the measures taken by other supervisors to address the issues they may be facing in relation to conflicts of interest.

Participants saw the shift in regulatory power as a natural phenomenon, while acknowledging that the closer relationship with the market allowed the exchange to carry out certain tasks better than a competent authority. Moreover, the importance of reputation for the exchange was seen as a powerful factor in ensuring high regulatory standards, irrespective of the ownership and structure of the exchange. Therefore there was significant support for IOSCO's recommendation of greater cooperation between supervisors and information flow between exchanges and supervisory authorities. Additionally, in the context of Europe, many did not see any need for national authorities to review and supplement the measures in place in their jurisdictions. Above all, participants urged for the relationship between the regulator and the exchange to be structured as a "partnership" geared towards shared objectives.

DERIVATIVES

7. Not only has the notional value of outstanding derivatives contracts increased, but new end-users – such as pension funds, insurance companies and sub-sovereign entities – have steadily entered the market, and derivatives have been used to perform an ever-widening variety of risk management functions. The discussion started with the observation that a properly functioning derivatives market is essential to support the cash market and fulfils a myriad of functions in the wider economy, allowing in particular product variety and hedging of risks. Nonetheless, the global policy community held clearly contrasting views on the role of derivatives in the economy, with some seeing in them the benefit of lowering risks, and others viewing them as only generating risk.

The participants identified **two main types of risks** posed by derivatives, mainly those related to (i) mis-selling and (ii) operational risk. The former type of risk could be controlled by conduct of business rules, in particular suitability principles, and disclosure. The latter type of risk had a diverse range of sources, such as the question of whether the pricing models were appropriately validated and whether banks' internal systems for lending criteria were keeping pace with the complexity of the market. The intense calculation requirements to measure these risks were in fact reaching the limits of the technology used by the banks, which, despite recent improvements, was becoming a limiting factor in risk management.

Credit derivatives posed specific risks; for example, due to the lack of a listed market with netting, the open positions were very high, and massively above the reference underlying, even though the net exposure would be zero. Thus the OTC nature of the market created a misalignment between the net risks and the open positions. Partially as a result of these concerns, there was a discussion in the US about whether credit derivatives/swaps should be subject to a netting/margining system. There was also discussion on the degree to which leverage provided for derivatives creates risks, which was generally not seen as a problem, whereas the leveraged credit market was seen as potentially risky.

Participants then came back to the comparison of **exchange-traded versus OTC derivatives** that had been broached during Session II. The significantly larger year-on-year growth since 2000 in the latter in comparison with the former was noted. The electronic markets had allowed the instruments to become global and also held the benefit of standardisation. On the other hand, OTC derivatives could be better tailored to clients. Disadvantages included the fact that the back-office operations of OTC derivatives were only recently becoming automated and that legal documentation had shortcomings. For example, despite recent progress, the credit default swaps (CDS) market ran a very serious operational risk due to the inability of manual processing to keep pace with the product and the resulting backlog on confirmations. Since unconfirmed credit derivatives always involved two or more parties, regulatory intervention in closing the gap was necessary. Equity derivatives did not pose the same systemic problems, since it was in credit derivatives that the active positions were so hugely larger than the reference debt.

There was some discussion on the interaction between the use of credit derivatives and the unwinding of the underlying entity in case of bankruptcy. There was agreement that bankruptcy laws had to be assessed in the context of a diversified creditor pool and more complex creditor schemes.

Certain improvements to the OTC markets could emulate the advantages of on-exchange trading (such as standardised contracts promoted by self-regulatory organisations) but other benefits (such as dynamic price limits and manual limits to prevent trader error) were more specific to exchange trading. In fact, OTC and on-exchange trading of derivatives were complementary, and, as contracts became more standardised, it would be easier for them to be traded on exchange. While

some thought that providing clearing for OTC derivatives would be sufficient, others noted a current demand from banks for credit derivatives to be launched on exchanges to capture the fuller benefits.

Finally it was noted that, with the increasing sophistication of the financial derivatives, the supervisory appreciation of the risks was becoming ever more difficult. In this context, the gap between the regulators' and the industry's technical knowledge of the instruments was identified as a potential source of inadequate supervision. The big problem for regulators was that they found it difficult to attract and recruit not merely those with technical product skills but also the technological skills to clearly understand the technology being deployed by exchanges and counterparties to create the contemporary financial market systems.

SECURITISATION – IMPACT OF THE NEW BASEL ACCORD

8. The discussion started with an overview of the global structured credit markets and explored how the **new Basel 2 requirements** would affect corporate and consumer credit portfolios. With new regulatory capital requirements, were new investment strategies in order? Among the issues discussed were the impact of low granularity and prepayments under the new rules, updated risk weights and risk-adjusted returns for various portfolios, and an overview of new investment strategies.

Under the so-called **Internal Ratings-Based (IRB) approach**, risk weights are not only dependent on external ratings, but also on the granularity of the portfolio. Initial concentration and prepayments, by reducing the effective number of exposures, may thus have a clear impact on regulatory capital. This is especially true if the loans which prepay are of a better quality, affecting risk weights through ratings and effective number of exposures at the same time.

It was pointed out that under Basel 2, sovereign debt portfolios, and emerging debt exposures especially, will see increases in risk weights and regulatory capital when compared to the previous regime. This increase in regulatory capital may lead holders of emerging markets sovereign debt portfolios to consider the potential benefits of rebalancing their exposures with structured finance.

It was noted that the regulatory terminology of Basel 2 did not correspond to the full scope of securitised products which acted as a limitation to measuring the risks and lowered the usefulness of supervisors' guidelines. Moreover, there were wide divergences in regulators' approaches to the regulatory capital required for different

securitised products subject to Pillar II review. This situation was further complicated by the uneven implementation of the new regime across the Atlantic. Paradoxical situations emerged, with some interpretations requiring the bank, for example, to hedge a risk with a counterparty that was less creditworthy. In the European context, it was noted that the supervisors were seeking to achieve common interpretations that would address industry's concerns.

It was acknowledged that the new regulatory capital requirements under Basel 2 created opportunities to reduce regulatory capital and increase yields, but this would involve additional complexity of products. The new framework would lead to new investment strategies capable of capturing value under the new rules. It was seen as a benefit that even if a bank did not use securitisation, it would be encouraged to use the criteria involved in securitisation and to collect data to understand the behaviour of the products over time. At the same time, to cope with the new system, the regulators had to be better trained with regard to the complexity of the products and to balance the desire to reduce risks to one simple factor and the need to be risk sensitive. There was some concern that the new framework may neglect the inter-linkages between risk factors in a portfolio. The fact that there might be different regulatory capital requirements around the world for the same product, even if it is being assessed on a stand-alone basis, was not seen as a problem, but convergence of approaches among supervisors was seen as critical to the success of the new regime. While it was seen as regrettable that the US was postponing its implementation, the EU's supervisory structure was seen as providing a good starting point to generate a convergence of approaches.

RISK MANAGEMENT IN A GLOBAL ENVIRONMENT

9. In the final session of the Conference, the participants turned to the role of the **trans-Atlantic dialogue** in addressing global risks in the financial markets. As markets became more integrated, the industry's support for removing obstacles to free trade in financial services was increasing. To make this possible, there was growing support for a model of global regulatory cooperation underpinned by the principles of flexibility, reliance on the equivalence of outcomes, and bilateral and multilateral modes of supervisory collaboration.

In this context, there was strong support for the **US Commodity Futures Trading Commission's recent decision** to reaffirm its long-standing policy of allowing

certain regulated **foreign futures exchanges** to provide electronic trading access to appropriate US customers without duplicative US exchange registration on the basis of a so-called “no-action” letter. The policy, which had been confirmed after an internal review that involved extensive consultation, was seen as a good model for opening up other market segments globally. Discussion towards a new regulatory approach in the US that would make more use of principles was also ongoing and would help global regulatory cooperation.

Participants also discussed the practical difficulties involved in **bridging diverging regulatory approaches.** The EU’s experience of building an internal market involved overcoming differences in many areas (such as anti-trust and mergers law and state aid policy) and demonstrated that the process of finding common solutions was not an easy one. Whether the convergence process involved the EU and the US, Member States of the EU or global partners, the key to success was building mutual trust and respect for the differences in regulatory approaches discovered in the process. Such differences rooted in separate historical paths were a fact of life and had to be assessed with a rational, objective and constructive spirit. Confronting the dramatic acceleration of the globalisation process required partners in the global financial sector dialogue to avoid any value judgements about each other’s regulatory approach and to seek equitable common solutions. Moreover, tackling the differences as early as possible in the dialogue helped to bridge the gaps and prevented them from becoming bigger obstacles. Success in the EU-US dialogue was critical to global convergence and had to be complemented by good partnerships with countries such as China, India and Japan.

In conclusion, participants agreed that the process of regulatory convergence had improved over the last few years even though further progress was needed. Practical solutions needed to enjoy political accountability but also to avoid the pitfalls of nationalistic instincts. Above all, a positive and rational mindset was considered the key to getting results.

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Wilton Park Reports are brief summaries of the main points and conclusions of a conference. The reports reflect rapporteurs' personal interpretation of proceedings – as such they do not constitute any institutional policy of Wilton Park nor do they necessarily represent the views of the rapporteurs.

END NOTES

[i] The total value of worldwide share trading grew almost five-fold from 1995 to 2005, reaching over USD 51 trillion. The derivatives market, particularly the segment of credit derivatives, grew even more dramatically. Trading in credit default swaps (CDS), for instance, having started only in the 1990s, reached notional amounts outstanding of USD 1 trillion in 2001 and USD 26 trillion by the second half of 2006. Growth in the foreign exchange markets was also very impressive, with average daily turnover amounting to almost USD 2,000 billion in 2004 - three times the volume of 15 years ago. This increase was all the more impressive as, with the introduction of the Euro, internal foreign exchange transactions disappeared within the Euro area. The volume of financial transactions had become disconnected from the real economy: turnover in the foreign exchange markets was more than 40 times the volume of world trade.

[ii] It was noted that assets under management by hedge funds and funds of hedge funds in the first quarter of 2006 amounted to about USD 1.2 trillion. Moreover, hedge funds' customer base has been broadening, with pension funds, life insurance companies and other institutional investors increasingly relying on hedge fund investment.

[iii] UCITS (Undertakings for Collective Investment in Transferable Securities) are investment funds established and authorised in conformity with the requirements of the Directive 85/611/EEC. This Directive lays down common requirements for the organisation, management and oversight of the fund. It imposes rules relating to fund diversification, liquidity and use of leverage. The UCITS Directive defines a list of eligible assets in which the fund can invest. Once authorised, a UCITS fund can be marketed to the public across the EU subject to notification in each Member State where it is sold. For more information: http://ec.europa.eu/internal_market/securities/docs/ucits/whitepaper/whitepaper_en.pdf.