Case 2: Hedge funds and financial markets

Especially the following features can be considered characteristic of so-called *hedge funds*:[1]

- Borrowing and leverage restrictions, which are typically included in collective investment schemes related regulation, are not applied, and many (but not all) hedge funds use high levels of leverage.
- Derivatives are used, often for speculative purposes, and there is an ability to short sell securities.
- More diverse risks or complex underlying products are involved
- Significant performance fees (often in the form of a percentage of profits) are paid to the manager in addition to an annual management fee.

Since the Global Financial Crisis (GFC), hedge funds have faced significant headwinds. Their returns have significantly deteriorated due to increased competition and fewer trading opportunities, which makes it hard to justify the generous remuneration structures they employ. In addition, regulators worldwide have started to pay them increased attention and have introduced among other measures, registration requirements, limits on leverage, and more disclosure. Nevertheless, no study or regulator directly linked the cause of the GFC to hedge funds.

Opinions on the impact of hedge funds on the creation and progression of the crisis are highly diverse. On one side critics argue hedge funds as prominent players in the unregulated shadow banking system, contributed in a substantial manner to the formation of the speculative bubble in American mortgage market and thus created along with other things the preconditions for financial crisis, others claim while they didn't cause the crisis they amplified the impact especially through the use of leverage, speculative short selling and sudden fire sales to in order to meet investor redemption demands. Others support the assertion that hedge funds not only reduced the detrimental effects of the crisis but even boosted economic recovery.

Politically, the activity of hedge funds had come into the spotlight long before the financial crisis, due to the role they played in the Asian financial crisis in 1997 and after the failure of Long-term capital management (LTCM) in the US in 1998. The Asian financial crisis was a prime example of hedge fund herding behavior, risks generated from massive leveraged short sales and subsequently fire sales stemming from deleveraging. The LTCM case brought forward to regulatory attention the systemic risks posed by overleveraged funds. Despite the aforementioned events, hedge funds remained largely unregulated or minimally regulated prior to GFC.

Try to provide aspects relating to the impact of hedge funds on financial market mechanisms and especially their capacity to create / exacerbate / mitigate the effects of financial crises. Do hedge funds need to be regulated and supervised? What can you say about the importance of the AIFM directive?

Use *Aatu Kokkila's* master thesis (see footnote) as a source.

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[1] See Technical Committee of the International Organization of Securities Commissions, *Hedge Fund Oversight,* IOSCO, 2009, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD288.pdf . The case is based on the findings of *Aatu Kokkila,* AIFMD Impact on European Hedge Fund Industry (unpublished Master's thesis. Aalto university School of business, Business Law 2016; to be found on the Materials subpage of the course Legal Aspects of Finance).