Hedge Funds and Offshore Financial Centers: New Challenges for the Regulation of Systemic Risks

Introduction

Since the 1980s, the dual forces of globalization—deregulation and liberalization of capital—led to a complete transformation of finance,¹ with rapid and growing movement of capital across borders.² This transformation, identified with innovative and highly complex and obscure financial instruments, resulted in a restructuring of the international financial system, raising concerns among policy makers and regulators, about financial stability.³ Hedge funds⁴ and Offshore Financial Centers (OFCs) provide appropriate lenses for assessing stability issues linked with this spectacular financial evolution. In fact, both have recently resurfaced on the global governance agenda as a result of concerns linked with their potential for financial instability. The impressive growth and increasing proliferation of hedge funds,⁵ as a mainstream alternative investment vehicle, indicate that they are likely to constitute critical non-bank financial institutions although the implications for financial stability, of their role, activities, and impact on financial markets, remain relatively underexplored. In turn, this has triggered a debate about the need for more stringent regulation seeking to forestall any future possibilities of financial instability and crisis. At the same time, OFCs have also witnessed surprising growth and importance⁶ against conventional wisdom that deregulation of financial systems would eventually undermine the competitive rationale for OFCs.⁷ Although stability issues related to OFCs have always been explained in terms of their weak, or absence of, regulatory frameworks and tax avoidance schemes, recent changes in their role and importance in the international

⁴ A loose concept to include all investment companies, organized as a limited partnerships, using high-risk techniques hoping high yield returns and whose funds are collected from wealthy investors, administered by professional investment managers, and, until recently, not widely available to the public.
⁵ Interest in the explosive growth in hedge funds even led to the publication of a journal specifically addressing trading, legal and other derivatives, Journal of Derivatives & Hedge Funds (JDHF) from May 2007, http://www.palgrave-journals.com/jdhf/index.html
capital markets have also given rise to new concerns about instability. \(^8\) Not surprisingly, the shared characteristics of hedge funds and OFCs, such as rapid growth and activities, lack of transparency resulting due to secrecy and anonymity rules, absence of, or weak, regulation, potential for criminal activities, raised concerns about their systemic risk implications, resulting in constant calls for more effective regulation and supervision. \(^9\) This paper examines the recent growth and importance of hedge funds and OFCs in capital markets, the extent to which OFCs, already operating under loose regulation, further facilitate hedge funds to move under the regulatory radar, and how their interaction potentially exacerbates systemic risks, and reinforces the case for stringent regulation.

The growth of hedge funds, as alternative investment vehicles, is due to their capacity to yield higher returns, relying on their flexibility to implement innovative strategies made possible by the absence of, or weak, regulation. \(^10\) Their importance in financial markets is highlighted as providers of diversification and liquidity and the ultimate holders of risk in the dynamic and growing credit risk transfer markets. \(^11\) For example, they benefit banks by reducing banks’ credit risks by taking assets off of their balance sheets, and improving their liquidity by providing a market for their securitizations and other financing strategies. \(^12\) Lack of transparency surrounding their activities makes it difficult, however, to quantify the extent of their role in the disintermediation of commercial banks’ traditional lending, although, in the US, the Shared National Credit Program (SNCP) provides some understanding of their activities. \(^13\) The recent rapid expansion of their investor base, identified with the rise of institutional investors such as pension funds and endowments, and attraction to the retail investor industry, investing in hedge funds, confirms their attraction as alternative investment vehicles. \(^14\) However, anxiety has grown about the inclination of hedge funds to take large risks, often associated with high leverage, lack of transparency surrounding their activities, the amount of assets they manage, and their relationship with banks as intermediaries, factors which, although not necessarily of a systemic

\(^8\) Ibid, 39
\(^9\) Existing literature always address hedge funds and OFCs in the light of these characteristics.
\(^12\) Ibid, Blundell-Wignall, Adrian, 43
\(^13\) According to SNCP data, nonbank lenders (including hedge funds) have increased their holdings of syndicated loans in the United States from USD 178 billion in 2002 to USD 267 billion, or 14 percent of total credits, in 2006. The data also suggest that hedge funds have become significant holders of some of the riskiest assets in the financial system: between 2002 and 2006, nonbank lenders increased their holdings of classified credits from 27 percent to 51 percent of total classified credits, http://www.federalreserve.gov/newsevents/press/bcreg/20090924a.htm
\(^14\) Callari, Aldo, Regulation of hedge funds: Why is it a social security issue? Center of Concern.
nature per se, can play a vital role in the transmission of systemic risks, causing contagion.\textsuperscript{15} In addition, the growing “retailization” of hedge funds,\textsuperscript{16} has generated more concerns about consumer investment protection, drawing the regulators and policy makers’ attention.\textsuperscript{17} Although consensus exists that hedge funds have not directly caused the recent market disruptions\textsuperscript{18}, the recent financial crisis, with the collapse of the two Bear and Stearns hedge funds, illustrates how they were at the origin of the crisis.\textsuperscript{19} The near-collapse of LTCM had already, in 1998, signaled the negative impact of hedge funds’ activities on financial markets and financial institutions.\textsuperscript{20}

The rapid increase and spread of capital flows across boundaries, facilitated by hedge funds, via OFCs, raises the critical issue of the soundness of a country's financial system, an essential component for economic growth, and macroeconomic and financial stability. While financial market development has contributed to economic growth across borders,\textsuperscript{21} it is also true that financial weaknesses in one country can rapidly spill over across national borders.\textsuperscript{22} Linkages between hedge funds and OFCs are key issues in financial market development and integration and provide critical insights into possible systemic vulnerabilities.\textsuperscript{23} The establishment and operations of hedge funds- already characterized by absence, or lax, regulation and supervision- primarily domiciled in OFCs,\textsuperscript{24} also with light regulatory treatment, secrecy rules, and favorable tax regimes, illustrate how the global reach of finance increasingly integrates economies and financial systems across borders, raising stability issues that cut across multiple jurisdictions.\textsuperscript{25}


\textsuperscript{16} Berzins, Janis, Crocker Liu, and Charles Trzcinka, Hedge Fund, Mutual Fund, and Institutional Fund Conglomerates: Risk and Return Choices for a Sophisticated Investor, December, 2006, 2, \url{http://www.fma.org/Barcelona/Papers/Berzins_BLT.pdf}

\textsuperscript{17} Garbaravicius, Thomas and Dierick, Frank, Hedge Funds and Their Implications for Fiancial Stability, European Central Bank, Occasional Papers, No. 34/August 2005, 5-8, \url{http://www.ecb.int/pub/scientific/opcdate/html/opsall.en.html}


\textsuperscript{19} Cox, Hugo, Hedge funds administration: lifting the veil, Alpha Magazine, April 2009; The Bear and Stearns funds collapsed as billions of dollars made on mortgage-backed bonds and collateralized debt obligations (CDOs) unraveled.


\textsuperscript{21} Supra 1, Kose, Prasad, ors, 9; The Economist, 4; M. Ayhan Kose, Eswar Prasad, Kenneth Rogoff, and Shang-Jin Wei,5

\textsuperscript{22} Schinasi, Garry, Safeguarding Financial Stability: Theory and Practice, International Monetary Fund, 2006, 3-8; Alexander, Kern, supra 3, 24

\textsuperscript{23} Financial System Soundness, A Factsheet - April 2009, \url{http://www.imf.org/external/np/exr/facts/banking.htm}

\textsuperscript{24} Terhune, Hannah, Offshore Hedge Funds: Dos and Don’ts, greenTraderLaw, 2005, 2: \url{http://www.greencompany.com/HedgeFunds/OffShoreDosDontsTerhune.pdf} ; Hedge funds legally domiciled in an OFC hold around one-half of the hedge fund assets reported by the TASS hedge fund database, with the British Virgin Island and the Cayman Islands being the most popular locations. Management of hedge funds is often conducted in or near major international financial centers such as London and New York, but the actual fund is registered in an OFC.

\textsuperscript{25} Supra, 7, p 42
order. First, the definition of OFCs as small distant islands in the sun offering some
advantageous tax outlets to onshore businesses, limits a thorough understanding of the types of
jurisdictions involved in such offshore activities. Secondly, conventional wisdom’s
categorization of OFCs as peripheral outlets offering tax advantages and lax regulatory
frameworks that allow for money laundering\textsuperscript{26} obscures their growing role and importance in the
internationalization of capital. A thorough understanding of OFCs in today’s international order
requires a paradigm shift, moving beyond the dual limitations, that captures the significance of
extent and types of capital market activities conducted through hedge funds, using OFCs which,
not only include distant small jurisdictions, but also advanced market economies such as the UK
and EU.\textsuperscript{27} These developments provide new perspectives on related financial stability issues.

The potential of hedge funds and OFCs to undermine financial stability has fuelled
intense debate about failures in existing frameworks and the need to design more stringent
national and international regulation. The conventional approach relying on market discipline
has been challenged for its failure to prevent or address the recent financial crisis,\textsuperscript{28} leading
policy makers, regulators, and academics to look for alternative models that would reduce the
threat of systemic risks.\textsuperscript{29} However, proposals for new and more stringent regulation of hedge
funds and OFCs have not been without any resistance both in the US and the EU.\textsuperscript{30} The first part
of this paper examines the growth and development of hedge funds and OFCs, followed by an
analysis of their impact on systemic risks and financial stability. In the third section, the
challenges that hedge funds and OFCs raise for regulation are examined looking at the state of
current and proposed regulation, at national and international levels. A note of caution, however,
relates to the data deficit that exists in relation to hedge funds and their activities which often
renders any conclusive analysis definitive, as in all studies of hedge funds.\textsuperscript{31}

\textsuperscript{26} Supra, 6; Nick Coates and Mike Rafferty: Geographic Patterns of Recent International Portfolio Investment Flows: Confusing Mess or
Conceptual Confusion? A Network Analysis Of The IMF Coordinated International Portfolio Investment Surveys (CPIS) 2001 and 2002,
\url{http://www.departments.bucknell.edu/management/apfa/stockholm%20papers.htm}

\textsuperscript{27} Switzerland has long been a centre for hedge funds it is home to about 150 registered managers, most of them funds of hedge funds. Since its
arrival in 1990s, London has emerged as the centre of Europe's hedge-fund management industry, handling about two-thirds of a total $325
billion in funds under management (the funds themselves are held offshore, in tax havens like the Cayman Islands). New York City remains
home to roughly double the number of hedge-fund managers as London. In 2005 Britain had the edge in performance, returning an average of
16.15%, almost twice the return of American funds. Estimates vary, but by one count Britain has about 700 hedge-fund managers today.

\textsuperscript{28} Wassim N. Shahin, De-Listing from NCCTs and Money Laundering Control Measures? A Banking Regulation Perspective, JMLC 2005, Vol.8
No.4, 320-327; Ibid, Alexander, Kern, 67

\textsuperscript{29} The Regulation of Hedge Funds under the prism of the financial crisis, Michel Aglietta Sandra Rigot, Recherches économiques de Louvain75
2009/1 \url{http://www.cairn.info/resume.php?ID_ARTICLE=REL_751_0005}

\textsuperscript{30} See part dealing with regulation at pages 19 onwards

\textsuperscript{31} Supra, ECB Occasional papers, 5
Origin and Growth of Hedge Funds

There is no legal or standard definition of a hedge fund. It is often described as an investment company, organized as a limited partnership administered by professional investment managers, whose funds are collected from wealthy investors, using high-risk techniques in the hope of yielding large profits. They date back to the 1940s and have grown impressively over the past ten years, despite the initial set back in 1990s caused by the LTCM debacle, which proved to be only a temporary setback to an accelerating long-term trend. From a mere 150 in 1969, they grew to 800 hedge funds holding $75 billion in assets (1994) and, by the beginning of the century, to some 6,000 managing some $ 600 billion, often engaged in derivative and other complex transactions and short-selling. By the end of 2006, the global hedge fund industry had 11,000 funds with about $1.43 trillion in assets under management. However, because hedge funds are not required to register with any financial regulator or supervisor, these numbers can only be estimated. Hedge funds are also dominant players in several markets and reportedly account for 18-22 percent of all trading on the New York Stock Exchange, and are here to stay.

Venture capital funds manage about $257 billion of assets, and private equity funds raised about $256 billion last year. Legally, the assets of a hedge fund are separate from the portfolio management, which is directed by the hedge fund advisor, who is typically also the general partner of the fund. The type of hedge fund governance and strategy which is characterized by the separation of ownership and control, where the partners are silent investors and generally take no part in management activities suggests that this organizational form may present complications in terms of determining ownership and tracing assets. In addition, the recent governance activism of hedge funds where they use their voting power to influence the behavior

33 The European Parliament uses the term “Sophisticated Alternative Investment Vehicles” (SAIVs), which would also encompass other alternative investment funds that differ from conventional Collective Investments. The Basel Committee on Banking Supervision (BCBS) employs the term “highly leveraged institutions” (HLIs), a label covering hedge funds as well as other institutions that are subject to very little or no direct regulatory oversight, have very limited disclosure requirements, and often take on significant leverage. The Multidisciplinary Working Group on Enhanced Disclosure (MWGED) prefers the term “leveraged investment funds”.
34 A.W. Jones & Co., the first hedge fund company founded in 1949 by A.W. Jones & Co., in Markham, supra. 17
35 Supra. 16, Cox, 6
37 Ibid, 100
38 Supra 9, 40.
39 In 2005, they accounted for 89% of the U.S. trading volume in convertible bonds, 66% in distressed debt, 33% each for emerging markets bonds and leveraged loans, 20% of the speculative grade bond volume, and 38% in credit derivatives.
Innovative hedge fund investment strategies, enjoying complete flexibility over their implementation and supported by the lack of regulation and supervision, led managers to look for minimum regulatory intervention and favorable tax treatment. In addition, the absence of mandatory reporting, and advantages offered by offshore domicile, also with few information and disclosure requirements and regulation, contributed significantly to their attraction as a financial engine of growth and expansion. This allowed for opaque and highly complex structures of their transactions with the potential to create excess risk-taking as illustrated by their extensive use of leverage and short-selling. Because of their leverage, and their active trading and management styles, hedge funds account for a much greater share in terms of market turnover, which explains in part why they have been important drivers of financial innovation and market liquidity, despite their relatively small size, and why their rising influence has generated concerns and interest. Their ability to use innovative instruments and their special source of capital, using regulated financial institutions-including prime broker dealers and banks, that supply them with their overwhelming proportion of their available leverage, encouraged hedge funds to adopt more adventurous investment strategies in the expectations of greater yields. Subsequently, banks also started setting up their own hedge funds providing similar services such as managers, custodian banks, prime brokers, investors. However, the interaction of hedge funds with regulated financial institutions and intermediaries, for the

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45 Last year was disastrous for hedge funds, lightly regulated investment pools as markets collapsed and investors withdrew money, triggering a cycle of forced selling that put more pressure on markets. The number of liquidations more than doubled the previous quarterly record of 344 set in the third quarter. Last year's liquidations marked a 70 percent increase from the previous annual record set in 2005. Just in the Americas, more than 200 hedge funds or fund families shut down or began to liquidate last year. At their peak, these funds managed $84 billion in assets. A record 778 hedge funds liquidated during the fourth quarter, capping a year that saw financial markets melt down and investors yank $150 billion of their money at the end of 2008, Hedge Fund Research Inc . The ranks of hedge funds were more than decimated as 1,471 hedge funds closed down last year, or nearly 15 percent of all funds, HFR said. Of that figure, more than 275 funds-of-hedge funds were liquidated in 2008, also a record. Meanwhile, 56 new funds were launched during the quarter, contributing to 659 that opened their doors throughout 2008. On a net basis, the total number of hedge funds fell by 8 percent to 9,284 last year.
47 Supra 12, 19.
48 Ibid, 22
49 Supra 14, 5-7; Nicholas Chan, Mila Getmancy, Shane. M., Haas, and Andrew. W., Lo, Do Hedge Funds Increase Systemic Risk?, Economic review, Fourth Quarter 2006, Federal Reserve Bank of Atlanta, 50
50 Thomas Garbaravicius and Frank Dierick, Hedge Funds and Their Implications for Financial Stability, European Central Bank, Occasional paper Series, No. 34/August 2005; 5
provision of services, such as the extension of credit to the hedge fund, exposes the financial institution to counterparty credit risks, raising additional concerns.

Another distinctive feature which gained the attention of policy makers and regulators, albeit of recent origin, has been the considerable expansion of hedge funds’ investor profile, moving from their traditional strategy of typically targeting only high net worth individuals and institutional investors, to official investment such as pension funds and retirement funds.51 Governments are seeking higher returns either through investment by individuals as their choice of instrument or investment in hedge funds by institutions, whether private or public, that manages individuals’ retirement savings.52 The broadening of the investor class has happened as a result of relaxation of accreditation requirements to the extent that few limits if any exist on who can invest in hedge funds.53 This growing “retailization” of hedge funds which, although do not currently have significant exposures to hedge funds, has led policy makers to start considering investor protection with regard to future hedge-fund exposure by these investors.54 During the last few years, hedge fund returns have become more sensitive to a number of asset classes, suggesting that they are taking on more risks.55 Changes in the investor base of hedge funds provide insights into the buildup of strengths and weaknesses in international financial markets.

**Offshore Financial Centers (OFCs)**56

The definition of an Offshore Financial Center (OFC) has always been problematic57 relying on loose concepts such as tax havens or simply centers that provide financial services

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51 Caliari, Aldo, Regulation of hedge funds: Why is it a Social Security Issue? Social Watch, 14/9/07; 52Danielsson, J. and Zigrand, J.P. (2007). “Regulating hedge funds”. In Financial Stability Review, Special Issue on Hedge Funds, No. 10, April, Banque de FranceIn some countries, a new category of investors with relatively modest financial means are now able to invest in them. In France, eg, hedge funds can now be accessed by individuals with a minimum amount of EUR 10,000 (Prada, 2007, 130). In Germany, German investors can buy hedge funds from Deutsche Bank in units of less than EUR 125 and UK regulators are considering reducing restrictions on marketing hedge funds to individuals (Financial Times, 2007a). Even regulated institutions such as mutual funds are increasing their investments in hedge funds (Danielson and Zigrand, 2007). Hedge funds now tap into a larger share of household savings that is channeled through institutional investors, such as banks, pension funds and retirement funds. Governments are also increasingly investing their pension money in hedge funds, where in the US, the SEC reports that about 20% of corporate and public pension plans were using hedge funds in 2002, up from 15% in 2001, and the trend is rising.  
52 Ibid, 50  
53 Ibid, 50  
56 This part and the next one rely on the proposition made by Nick Coates and Mike Rafferty (supra 7 and 25) regarding the new role of hedge funds in international markets and international financial flows.  
57 Johnston, R. Barry, Darbar, M. Salim and Zephirin, G. Mary, Assessing Offshore: Filling the Gap in global surveillance, Finance and development, IMF, September 2003, 32; [https://www.imf.org/external/pubs/ft/fandd/2003/09/pdf/darbar.pdf](https://www.imf.org/external/pubs/ft/fandd/2003/09/pdf/darbar.pdf). The most practical definition characterizes OFCs as centers where the bulk of financial sector transactions on both sides of the balance sheet are where individuals or companies that are not residents of OFCs, where the transactions are initiated elsewhere, and where the majority of the institutions involved are
such as low or zero taxation; moderate or light financial regulation; banking secrecy and anonymity to non-residents. A common definition is one which includes “jurisdictions with relatively large numbers of financial institutions engaged primarily in business with non-residents” and whose financial systems display external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic operations. Relying on strict banking-secrecy rules, OFCs, such as Luxembourg, Switzerland and Singapore, have the advantage of providing foreign businesses and rich individuals with low or no taxes, political stability, business-friendly regulation and laws, and discretion as most OFCs do not levy capital-gains or inheritance taxes. Other OFCs, including many in the Caribbean, do not have any laws against tax evasion because they impose no income taxes. Criticisms leveled against OFCs that they have a distorting effect, depriving onshore businesses of legitimate business, by using taxes to attract mobile financial capital without any “real” business underpinning it, are disputed on the basis that foreign investors are attracted to OFCs because companies’ subsidiaries in OFCs add value by providing important intermediate inputs used by its operations elsewhere, and by helping multinational companies lower their effective tax rates. At origin, OFCs’ association with tax evasion led to growing concerns about financial stability, of the volume of capital located in such jurisdictions.

Unbundling the complexities surrounding the interaction between hedge funds and OFCs requires a paradigm shift transcending the two limitations imposed by conventional approach to OFCs. First, it is no longer possible to rely on the traditional and restrictive definition of OFCs as distant small tax havens islands generally providing ideal domiciles where it is relatively easy to controlled by non-residents, The Role of the IMF, Monetary and exchange Affairs Department, IMF, June 23, 2000, http://www.imf.org/external/np/oshore/2000/eng/role.htm


59 Offshore Financial Centers, The Role of the IMF, Monetary and exchange Affairs Department, IMF, June 23, 2000: “is a centre where the bulk of financial sector activity is offshore on both sides of the balance sheet, (that is the counter parties of the majority of financial institutions liabilities and assets are non-residents) where transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents.


62 Offshore Financial Centers, The Assessment Program—A Progress Report, Prepared by the Monetary and Financial Department, approved by Ulrich Baumgartner, February 8, 2006


64 Tax Havens Creating Turmoil, Evidence Submitted to the Treasury Committee of the House of Commons by Tax Justice Network, June 2008: estimates that tax revenues lost to OFCs exceed US$ 255 billion a year, although this is disputed; Senator Levin has indicated that a study suggests that America loses up to $70 billion a year to tax havens. Ireland, considered to be a tax haven, last year recovered almost €1 billion in unreported tax revenues from banks in the Channel Islands. South Africa reckons it is losing 64 billion rand ($ 8.8 billion) a year to tax havens, http://www.taxresearch.org.uk/Documents/CreatingTurmoil.pdf
set up and operate a hedge fund. A broader definition illustrates that the UK, EU countries, Switzerland, Luxembourg provides offshore regimes and channels for hedge funds, although both EU and UK hedge funds tend to be more concentrated offshore, albeit managed onshore. Second, the popular image of OFCs as low levels of tax and regulatory regimes supported by secrecy rules facilitating money laundering and financing of terrorism, no longer provides a complete picture of the role and importance of OFCs in the present international financial structure. In fact, the period following financial deregulation, the growth in number of OFCs illustrates that they have started to develop into active and important players in more mainstream financial services, acting as critical mediation points in international capital markets. It is the combined effects of this growth and impact of hedge funds and OFCs that led the global community to express concerns for the stability of the international financial system.

OFCs can no longer be identified only as tax free destinations for they have grown more relevant as financial centers hosting complex financial activities. Recent developments illustrate a new trend of OFCs’ booming business and close links with the internationalization of capital flows making them an integral part in the functioning of international capital markets. OFCs, often referred to as the middlemen of international financial transactions, play a critical role in international portfolio flows across the globe, moving somehow away from its traditional regulatory arbitrage functions, and raising issues of nationality and residence. Jersey, for example, which initially relied on its low-tax repository of cash to build up a sophisticated private-banking and trust business, has more recently moved into the corporate business of structured finance and the administration of investment funds. IMF calculations suggest that OFCs on balance sheet role in cross border transactions was something in the order of $4.6

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66 Supra 6, Coates and Caferty, 6; supra 6, Places in the sun, 3-5


69 Supra 7, Nick Coates and Mike Rafferty: Geographic Patterns of Recent International Portfolio Investment Flows; Andrew K. Rose and Mark M. Spiegel, Offshore Financial Centers: Parasites or Symbionts? Revised: April 4, 2006, [http://faculty.haas.berkeley.edu/arose/RevOFC.pdf](http://faculty.haas.berkeley.edu/arose/RevOFC.pdf); The Cayman Islands, for example, developed as an OFC due to its participation in the formation of Euro-dollar markets in the 1970s and 1980s (Roberts, 1995). In 1968 the Asian dollar market developed in Singapore. By the 1970s equities markets in Luxembourg became a focus for international investment as investors were exempted from any withholding tax (IMF, 2000:5).


71 Supra 7, Nick Coates, Mike Rafferty & Rob Nicoletti.

72 Supra 7 and 25
trillion in 1999, with around 50 per cent being intermediated through OFCs, where they are often recycled. The variety of offshore services such as Special Purpose Investment Vehicles, shell and brass plate companies, offer financial services such as banking, insurance, and securities, provide financial channels, where nationality and recorded form of transactions can change very easily, without any change in their economic content. Financial and nonfinancial corporations, registered in OFCs because of attractive incentives such as tax advantages and lower registration and establishment costs, increasingly resort to Special Purpose Vehicles for securitization. In addition, most banks located in OFCs are branches or subsidiaries of international banks. This development provides alternative avenues for MNCs and other international investment institutions to diversify organizational forms. This rapid growth, and variety, of international financial transactions due to international portfolio investment is illustrative of OFCs’ new role, potentially leading to global imbalance. As business in OFCs develops, these jurisdictions no longer sit at the fringes of the global economy. The Cayman Islands hosts 8,000-plus hedge funds, more than half of the world’s offshore hedge funds, and is the world's fifth-largest banking centre, with $1.4 trillion in assets; the BVI, home to almost 700,000 offshore companies, provides setting up and registration of hedge funds within a couple of days, and Jersey's 46 banks, 1,055 investment funds and over 200 trusts administer over £700 billion in assets on the island. San Marino aspires to become a fully fledged financial centre which offers light but firm regulation although it wants to avoid a reputation as a tax haven or a dubious destination to park questionable funds. Singapore is trying to compete with Hong Kong as a home for hedge-fund investors and bankers by offering permanent residency in two jurisdictions.

73 Supra 7 and 25
74 Of this $4.6 trillion, $0.6 trillion passes through the Caribbean, $1.0 trillion through Asia, and most of the remaining $2.7 trillion is accounted for by London. Reporting of OFC transactions to the BIS tends to be limited to major financial centers. Of the smaller OFCs like Bermuda, Liberia and Panama most do not report to the BIS.
75 Supra 36, Barry Johnston, Salim Darbar, and Mary Zephrin, 33
76 Supra 7, 39
77 In the 1980s, Balance of Payments statisticians began to observe that a global financial imbalance had opened up of around $US40 billion dollars (suggesting that global cross border inflows of financial account liabilities were greater than reported outflows). This imbalance was not stable year to year, but took a sharp upward step in the early 1990’s, reaching $US210 billion dollars. For instance the imbalance on global IPI amounted to $US 170 billion in 1997 (IMF 2003, Humphreys 2003).
79 OFFSHORE FINANCE, What it takes to succeed, Feb 22nd 2007; offshore holdings now run to $5-7 trillion, 7 times as much as two decades ago and make up of 6-8% of worldwide investment under management. Canadian direct investment in OFCs increased eightfold within 10 years to US$ 75 billion, mostly in Caribbean countries. Of the Cayman Islands’ $1.3 trillion in bank deposits, 93% are interbank bookings. http://www.economist.com/specialreports/displaystory.cfm?story_id=E1_RGJVTRS
years and a low-tax, business-friendly environment. The Channel Islands, Isle of Mann, Bahamas and the Caymans, apart from providing tax incentives during the 1970s, also acted as Securities Issuing Centers and Special Purpose Vehicles, and Collective Investment Schemes as well as host to insurance companies, pension funds and fund managers. This new development of OFCs, where hedge funds are usually incorporated, albeit managed onshore, raises interesting challenges for stability issues, especially in the context of a series of events that triggered renewed regulatory interest about the implications of IPI for financial stability.

**Systemic Risks: Hedge Funds and OFCs**

The rapid growth of the hedge funds industry and their active role in financial markets, which far outweigh the importance of their size alone, continue to attract policy makers’ attention, in view of their potential for undermining the stability of the international financial system. Systemic risk is not always easily defined, although it can be referred to as negative externalities linked to an institution's failure propagating contagion- causing other institutional failures- which eventually negatively affecting the larger economy. Destabilizing failures in markets and regulation, changes in financial sector structure, failure of risk management to keep up with financial innovation, and leveraged financial institutions taking on excessive risks without internalizing systemic risk, are examples of vulnerabilities that can potentially cause instability. Systemic risk in hedge fund investment can occur either directly with a wave of

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82 Bartram, S. and Dufey, G., ‘International Portfolio Investment: Theory, Evidence, and Institutional Framework’, Financial Markets, Instruments, 2001, V 10. No 3; The Netherlands and Netherlands Antilles, for instance, issue securities with an inexpensive administration and corporate legal system and no holding taxes on interest, dividends and capital gains. These OFCs are central to issuing special corporate vehicles that issue securities. SPV are rapidly growing and can be used to issue shares, bonds, derivatives or raise capital in other ways, and can be international business corporations, which are basically shell companies and brass plate companies where director’s identities can in some instances be concealed. SPV are closely associated with securitization where the parent company transfers asset-backed securities to the SPV such as portfolio of mortgages, loans and receivables. The SPV then offers them as bonds to investors protected with underlying assets.
83 At end-2005 close to 70 % of total (global) capital under management of the hedge funds was domiciled offshore. The share of offshore-domiciled hedge fund capital managed from Europe was even higher (close to 77%).
84 The turbulence in world bond markets in 1994, and the Asian financial crisis of 1997, and more recently, the 2008 credit crisis.
85 The ECB Financial Stability Review of June 2006 concerns relate to: 1) rising share of less liquid assets in hedge funds’ investment portfolios; 2) increasingly similar positioning of individual funds within broad investment strategies; 3) rising correlation not only within the same but also among differing strategies.
86 Schwarcz, L., Steven, Systemic Risk, Duke Law School Legal Studies Paper No. 163,Georgetown Law Journal, Vol. 97, No. 1, 2008; A “systemic crisis” occurs when a shock affects “a considerable number of financial institutions or markets in a strong sense, thereby severely impairing the general well-functioning (of an important part) of the financial system, DeBandt and Hartmann (2002); another description of systemic event as a situation where: “shocks to one part of the financial system lead to shocks elsewhere, in turn impinging on the stability of the real economy (pg. 31)”; Bordo et al. (1998); “major damage to the financial system and the real economy p. 5; In our view, an essential feature of systemic risk is when financial shocks have the potential to lead to substantial, adverse effects on the real economy, e.g., a reduction in productive investment due to the reduction in credit provision or a destabilization of economic activity. Indeed, it is the transmission of financial events to the real economy that is the defining feature of a systemic crisis, and which distinguishes it from a purely financial event.Counterparty Risk Management Policy Group (CRMPG, 2005)
87 Viral V. Acharya, A Theory of Systemic Risk and Design of Prudential Bank Regulation, London Business School, NYU-Stern and CEPR.
88 Paulo Mauro and Yishay Yafeh, Financial Crises of the Future, Finance&Development December 2007, Volume 44, Number 4,
hedge fund collapses, through fire sale of assets and subsequent disruption in asset prices, to eventual losses at systemically important counterparty institutions such as large prime brokers. Changes in hedge funds’ international investor base, and their investment allocation behavior, are also critical for understanding buildup of strengths and weaknesses in the international financial system.\textsuperscript{89} Indirectly, the effect of forced hedge fund liquidation on secondary market performance, in particular on rising volatility and disappearance of liquidity, could impact on systemically important financial institutions whose assets are depreciated.

The impact of hedge funds, as a source of systemic risk, on the real economy, can be assessed in terms of symbiotic linkages with the financial sector and the economy, reflected through the role that financial intermediaries, such as banks, play in the provision of credit.\textsuperscript{90} Discussions of this type of direct linkages from hedge funds to real economic activity through the banking system are common.\textsuperscript{91} Such linkages to the real economy might occur through banks’ direct exposures to hedge funds,\textsuperscript{92} or disruptions to capital markets that hinder credit provision or allocation. Failure of a large individual or a group of hedge funds, serious mismanagement of exposures to hedge funds at an individual bank or banks, or the negative impact of hedge fund activities on financial markets, can trigger financial instability,\textsuperscript{93} when the spill-over effect escalates on other channels leading to contagion.\textsuperscript{94} Credit exposure to hedge funds may create externalities in the banking system and where the exposure represents a significant share of bank capital, a large shock to hedge funds could weaken banks and impair their ability to provide liquidity or credit. Given that commercial banks and securities firms are directly linked to hedge funds through their counterparty exposures, a bank’s large exposure to a hedge fund that defaults or operates in markets where prices are falling rapidly, may reduce its ability or willingness to extend credit to deserving borrowers.\textsuperscript{95} As a consequence of disruption

\textsuperscript{91} John Kamhbu Til Schuermann Kevin J. Stiroh , HEDGE FUNDS, FINANCIAL INTERMEDIATION, AND SYSTEMIC RISK, Federal Reserve Bank of New York, August 1, 2007, http://fic.wharton.upenn.edu/fic/papers/07/0717.pdf; while the magnitude of this exposure remains unclear, BIS estimates that banks’ direct exposure to hedge funds has been growing proportionately with the hedge fund industry itself. It should be noted, however, that banks’ current exposures to hedge funds are heavily collateralized and the Financial Stability Forum (2007) estimates that both the current and potential exposure net of collateral of core firms to hedge funds are quite modest in the aggregate. Moreover, each bank has a clear self-interest to manage and mitigate the risk of these exposures.
\textsuperscript{93} Supra 18, ECB Occasional Paper
\textsuperscript{95} An externality is an impact of one party’s action on others who are not directly involved in the transaction.
of a bank’s lending activity, due to insolvency or capital shocks, viable investment projects are deprived of funding and economic activity is reduced. A sudden decline in asset prices, triggered, for example, by the unwinding of a highly leveraged hedge fund, can reduce the value of that collateral, or generate liquidity risk and further price declines as investors sell into the falling market to meet margin calls. Bank lending, however, is not the only form of credit provision and other forms such as capital markets, are rising in relative importance. The same rationale of market disruption is also applicable to capital market institutions, potentially limiting the provision of credit, with real economic effects. Hedge funds, in particular, are active traders and contribute to increased market efficiency and liquidity through their frequent trading and ability to exploit arbitrage opportunities. The potential for liquidation of a highly leveraged institution may lead to volatility and sharp asset price declines that heighten uncertainty about credit risk and disrupt the intermediation of credit.

Over the years, and more recently during the credit crisis, repeated scandals associated with hedge funds’ risky trading activities, and the serious impact on the real economy, have also prompted concerns about their potential for systemic instability. Although hedge fund scandals are not new, it was the famous recent scandal of the Long-Term Capital Management (“LTCM”), a hedge fund that lost ninety percent of its $4.8 billion in 1998 as a result of its trading positions that brought hedge funds to the surface of governance concerns. There is consensus that the recent financial and economic crisis originated with the implosion of two of Bear Stearns' hedge funds, the Bear’s Credit Strategies Master Fund and its sister Enhanced Master Fund, in 2007, triggering the downturn, although, since 2006, questions were raised as to whether Bear was using the funds to "unload excessively risky or troubled assets" that it could

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96 According to the U.S. Flow of Funds, bank credit accounted for 39% of outstanding credit market instruments for nonfarm, nonfinancial corporations in 2005, down from 52% in 1985, which reflects the growing importance of alternative sources of credit such as corporate bonds and commercial paper.

97 Supra 42

98 As far as 1920, Charles Ponzi, an Italian immigrant, began advertising that he could make a 50% return for investors in only 45 days. In March of 1932, Ivar Kreuger, a Swedish businessman who had cooked the books of his match manufacturing business and forged $142 million of bonds, shot himself in the head. It was reported that he may have burned through $400 million of investor money by falsifying the accounts of 400 separate companies. Until Madoff came along, the Equity Funding scandal may have been the largest fraud in dollar terms in U.S. history. A publicly held company whose shares traded on the New York Stock Exchange, the top executives falsified 64,000 insurance policies that were used to report revenues of $2 billion.

99 Hugo Cox, Hedge fund administration: lifting the veil, Alpha Magazine, April 2009; The Bear and Stearns funds collapsed as billions of dollars of bets made on mortgage-backed bonds and collateralized debt obligations (CDOs) unraveled, and no one wanted to buy them when the time came to try to sell some of the funds' sub-prime mortgages.

100 LTCM was a hedge fund that brought the financial world to its knees when it lost $4 billion trading exotic derivatives. It leveraged $4 billion into $100 billion in assets and the $100 billion became collateral for $1.2 trillion in derivatives exposure. Finally, when Russia defaulted on its bonds- many of which Long-Term owned, in 1998, this stirred up the world’s financial markets in a way that caused many additional losing trades for Long-Term. By the spring of 1998, LTCM was losing several hundred million dollars per day. By August 1998, LTCM had burned through almost all of its $4 billion in capital. With $1.2 trillion dollars at risk, the economy could have been devastated if LTCM’s losses continued to run its course. Finally, the Federal Reserve and Wall Street’s largest investment banks decided to rescue Long-Term. The banks ended up losing several hundred million dollars each.
Following the collapse of Bear, two years later, Lehman Brothers has been liquidated, Merrill Lynch was rescued by Bank of America and the entire global economy has faced the worst recession for 70 years. The Madoff Ponzi scheme, with its main hedge fund, the Ascot, followed by closures of other hedge funds, confirm the linkages between hedge funds and massive financial fraud that can result in market meltdown. Various investors had, through various hedge funds, invested with Madoff. The Madoff scheme revealed how the use of a legitimate broker-dealer business intermingled with a fraudulent hedge fund with the ultimate objective of diverting investors’ money. Amaranth is another example where state pension funds were invested in a risky hedge fund. However, there are strong indications that, albeit such scams and closures, hedge funds are here to stay with the top three prime brokers still controlling 62 percent of hedge fund industry capital, leading regulators to believe that contagion is likely to reemerge. Three aspects of the LTCM case are interesting for understanding the role and importance of hedge funds for stability: the extent of the company’s leverage, the extent of its use of derivatives, and the fact that leading banks lent to LTCM apparently without being well informed of either its activities or its other sources of financing.

Hedge funds and OFCs are also often portrayed as attractive channels for criminal activities as a result of the globalized financial economy allowing for capital to move around the globe instantly providing openings for drug traffickers and money launderers and rogue nations.

101 James Quinn, US Business Editor, Telegraph.co.uk, 20 Aug 2009, http://www.telegraph.co.uk/finance/financetopics/financialcrises/6061849/Case-will-throw-light-on-funds-before-Bear-Stearns-collapsed.html; (Financial Stability Forum, 2000, p. 5), First, the East Asian financial crisis resulted in countries’ concern about the impact that destabilizing activities of hedge funds in their markets potentially disrupting their economies. Brouwer (2001, cited by Cornford, 2005) Some authors claimed that operations of macro hedge funds were an important source of instability in the region’s financial markets in 1997-1998, (Fox, 1998; IMF 2004, p. 146-8) although this contention has been questioned by others.

102 Bernie Madoff’s $50 Billion Ponzi Scheme, Robert Lenzner, http://www.forbes.com/2008/12/12/madoff-ponzi-hedge-pf-fi-in_jr_1212toesus_inl.html; was to be one of the first jailed investors of the 2008 market meltdown

103 Citigroup's Old Lane Partners, once managing $4.4 billion, was closed in July 2008 and D.B. Zwirn shuttered his $4 billion Zwirn Special Opportunities fund amid a Securities and Exchange Commission’s investigation and investor redemptions. Other major closures included Ospraie Management's flagship $3.8 billion commodities fund; two funds at Tontine Capital Management that had run $4 billion; two Highland Capital Management funds, which had $3.5 billion; and two Peloton Partners funds that had managed $3.5 billion, the magazine said.

104 Lieff Cabraser Securities, Bernard L. Madoff Investment Securities LLC Financial Fraud, such investors include Fairfield Greenwich Group, Tremont Capital Management, Ascot Partners, Maxam Capital Management http://www.liefcabraserssecuritie.com/cases/madoff.htm?gclid=CHSoDmVjgCFRKAxgo


106 In 2006, the regulation of hedge funds drew renewed attention following the USD 6 billion loss by hedge fund Amaranth and the 75% loss of its USD 13 billion fixed income trading by hedge fund Vega.


108 Joseph A. Giannone Thomson Reuter, UPDATE 2-Meltdown, Madoff decimated hedge funds in '08, (joseph.giannone@thomsonreuters.com; +1 646 223 6184; Reuters Messaging: joseph.giannone.reuters.com@reuters.net); Among other findings, Hedge Fund Research

in need of cash. The other risk associated with OFCs is that market integrity may be compromised by financial crime such as money laundering. Concerns have been expressed about the huge growth in the use of hedge funds and OFCs for money laundering and financing of terrorism, raising systemic risk and financial stability concerns, due to illicit money being hidden away in islands with variable supervision. Several instances illustrate the concerns. The recent (2008) Stanford investigation into an $8 billion fraud is another illustration of the continued use of OFCs as offshore investment vehicles to defraud investors who invested their savings into Stanford’s offshore schemes. Enron's 700 companies in Cayman allowed its corrupt bosses to minimize taxes but also manufacture earnings. This is the underappreciated real cost of OFCs, rather than lost tax revenues. Financial Institutions’ liquidity problems resulting from the credit crisis, compared to availability of huge amounts of illicit money (capital) ready to be injected into (rescue) financial institutions illustrate the high probability of money launderers seizing the opportunity presented by the crisis to develop new ML/FT channels.

Extensive use of leverage is considered to be one, if not, the most important feature of hedge funds that can trigger systemic risk, as recently highlighted by the FSF and IMF in their analysis of the causes of the crisis. Leverage constitutes the fire-power of hedge funds which, when combined with a rapid and focused trading style, allows hedge funds to have a much

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111 Ibid 1/6.
112 Ibid 2/6 Abacha of Nigeria, Mohammed Suharto of Indonesia and Marcos of Philippines illustrate corrupt leaders who have looted their countries helped by secrecy offered by some OFCs. Some of the money used in the 9/11 terrorist attacks were channeled through Dubai now an established OFC. The accounting scams at Enron, Parmalat and Tyco were made easy by complicated financial structures based in OFCs Tyco and Parmalat both had thousands of subsidiaries offshore which its managers used not only to reduce their tax bills but also to loot the company.
115 Antonio Maria Costa, Executive Director of the U.N. Office on Drugs and Crime, warns that "cash-rich mafia groups have been channeling funds into banks desperate to survive the global credit crisis": INTERVIEW-Ample signs of mafia millions buoying banks—UN, 2009-02-09 (Reuters), By Mark Heinrich, http://www.reuters.com/article/topNews/idUSTRE52A44I20090311, The United Nations claims that it has enough indication that in the second half of the 2008 crisis liquidity was the banking system's main problem and that illicit money has been used to keep banks afloat in the global financial crisis. "There were signs that some banks were rescued in that through "interbank loans funded by money that originated from drug trade and other illegal activities." (Interview of Maria Costa, Executive Director of United Nations Office of Drugs and Crime, Vienna, reporting by Boris Groendahl, editing by Charles Dick, ), Austrian weekly Profil, Global Research, March 15, 2009, http://www.globalresearch.ca/index.php?context=va&aid=12718
116 AIMA Breakfast Address on the Alternative Investment Fund Management Directive, HM Treasury, 7 July 2009, http://www.hm-treasury.gov.uk/speech; (IMF, 2008; and FSF, 2008); In their April 2008 analysis of the causes behind the current crisis, both the IMF and the Financial Stability Forum (FSF) highlighted the striking nature of the extent of leverage—the ratio of debt to equity—taken on by a wide range of institutions and the associated risks of a disorderly unwinding: "Consultations I’ve had with prosecutors and law-enforcement officials around the world show there is ample evidence that the banking system's illiquidity is providing a unique opportunity for organized crime to launder their money," Costa told Reuters. "Just about every financial centre can be characterized as part of the problem," "You have the supply -- an organized crime industry with enormous amounts of cash, estimated at $322 billion in 2005, not any more stored in banks -- and the demand, a banking sector strapped for liquidity," said Costa. "This is a supply- and demand-driven situation. Our intuition, based on logic, is now supported by ample evidence." Asked where cases were occurring, he said: "Traditionally, Europe and North America are the places where, as financial centers, most money would be laundered".; INTERVIEW-Ample signs of mafia millions buoying banks—UN, 2009-02-09, (Reuters), By Mark Heinrich.
bigger impact on market turnover. Hedge funds can leverage themselves with very high multiples, either directly by borrowing from prime brokers or, indirectly through selling credit derivatives, making them especially vulnerable to a sudden decrease in market liquidity. Moreover, there is a generalized view that hedge funds’ leverage, in the aggregate, only keeps increasing. The main problem, however, is posed by the lack of reporting requirements on hedge funds, which makes it very difficult to assess the extent of hedge funds’ leverage, especially through their derivatives exposure.” One example of the type of risk associated with hedge funds is the sequence of negative events starting with losses on leveraged market positions where leveraged market risk can, if not supported by adequate liquidity reserves or borrowing capacity, lead to default on the fund’s obligations to prime brokers and other financial institutions.

Measuring illiquidity exposure in hedge funds is another central aspect of systemic risk, directly related to hedge fund failures and estimates of a fund's probability of liquidation are critical for improving the stability of global financial markets. Hedge funds are typically viewed as being liquidity providers in the capital markets and are generally considered to help disperse risk more widely. However, generalized illiquidity plays an important part in general market collapse as the more illiquid the portfolio, the larger the price impact of a forced liquidation or fire sale, which erodes the bank’s risk capital that much more quickly. In the presence of leverage, the combination of relatively illiquid assets and short term financing exposes the hedge fund to possibly significant liquidity risk. If many hedge funds or financial institutions become more highly correlated during times of distress and, as financial institutions are interrelated, the illiquidity crisis can cascade quickly into contagion causing a global financial crisis. The collapse of LTCM in 1998, Bear and Stearns, and Lehman Brothers in September 2008, made it clear that hedge fund liquidations can be a significant source of

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118 A figure from 2004 indicated hedge fund leverage in the form of bank debt to be at an average of 141% (Financial Times, 2004b). (Papademos, 2007, p. 115) The Vice President of the European Central Bank claimed that “the total leveraged assets of an individual hedge fund can sometimes be quite significant and comparable with the size of some systemically important banks”.
119 Ibid 54, p109, according to one author, effective leverage “has become notoriously difficult to measure, due to the difficulty in capturing the effect of different layers of leverage, and in particular the leverage embedded in the most complex forms of credit derivatives.
120 The credit crisis originating in mid 2007 with the failure by Bear Stearns, of its hedge funds, is an example an event that accelerated the recent severe financial market dislocation.
122 Supra 42.
123 John Kambhu, Til Schuermann and Kevin Stiroh, Hedge Funds, Financial Intermediation, and Systemic Risk, Staff Report, no.91, Federal Reserve Bank of New York, July 2007, 14
systemic risk. The revelation about Madoff’s hedge fund, Ascot Partners, being a major financial scam, raised fears about its impact on several hedge funds possibly going into liquidation. In addition, concerns exist regarding risks associated with a decline in asset-market liquidity resulting from the failure or winding down of one or more major hedge funds. A particular concern is that, in illiquid markets, hedge funds may be forced to sell positions to meet margin requirements, driving down market prices. Because of such risks, supervisors focus on banks’ ability to identify and mitigate the risks associated with a sharp decline in market liquidity.

Counterparty credit risk is the single most important risk for financial institutions in their interaction with hedge funds. Although the transfer of risk from banks to hedge funds allows banks to better manage their credit risks, some concerns still remain. One is that this risk hasn’t been transferred so much as transformed into counterparty credit exposure to the hedge fund. For example, in the purchase of credit protection on a loan via a credit default swap with a hedge fund, a bank would no longer bear direct credit risk to the original borrower but would instead have counterparty credit risk to the hedge fund. Assessing counterparty credit risk depends on the net exposure between two institutions which can change as either party may become the net debtor. Current exposure, the net exposure at current market values, or potential future exposure, which is the maximum amount to which an exposure could grow over a future time period, if markets move against the hedge fund, provide two ways of assessing counterparty credit risk. Banks also “stress” potential exposures to estimate how they may grow under adverse market conditions. Still, systemic concerns remain. In a crisis, interlocking credit exposures would be the key mechanism by which risks would be transmitted from one institution to another, potentially leading to a systemic situation. Excessive leverage and poor counterparty credit risk management practiced by banks and other creditors raised concerns that market players seeking to sell at once could have negatively affected asset prices across markets, indirectly affecting other market participants. Absence of data such as counter-party credit exposures, the net degree of leverage of hedge-fund managers and investors, the gross amount of structured products involving hedge funds, renders any conclusive assessment of the magnitude of current systemic risk exposures with any degree of accuracy, almost impossible.

124 Supra 93.
125 Supra 120, John Kambhu, Til Schuermann and Kevin Stiroh, Hedge Funds, Financial Intermediation, and Systemic Risk
126 Supra, ECB Occasional Paper
The assessment of potential systemic risks associated with financial flows arising out of financial activities of hedge funds located in OFCs is complicated by the strong growth of the hedge fund industry and the increasing complexity of the instruments they trade in.127 Offshore hedge funds, with many billions of dollars available at to switch at short notice between markets, are often blamed for intensifying financial crises such as the 1997 Asian currency and stock market crash; but it is equally possible to argue that they have a smoothing effect on global financial volatility.128 Three main concerns exist about hedge funds operating in OFCs: existence of lightly supervised OFCs encourages regulatory arbitrage that may result in the establishment of rogue financial institutions; impediments to consolidated supervision in the OFCs result in supervisory gaps over important activities of a financial institution; and lack of information about the volume and type of activities conducted in the OFC. Offshore establishments provide alternatives to domestic financial institutions that are often subject to strict prudential regulations and high reserve requirements. Challenges associated with OFCs’ ineffective financial supervision, strict bank and corporate secrecy rules that hinder investigation, arrangements that facilitate money laundering and other financial crimes, and loss of tax revenues onshore, allow hedge funds to escape the regulatory eyes, creating risks of some OFCs as a source of systemic problems nationally and globally.129 Supervision concerns include weak licensing systems and know your customer requirements, which make it difficult for consolidated supervision by countries whose financial institutions have operations in OFCs. In the Asian crisis, large, undetected, and poorly accounted for offshore funds contributed to credit expansion in the region, led to increasing exposures to liquidity, foreign exchange, and credit risks, and had systemic effects on the financial systems of individual countries concerned.130 The turbulence in world bond markets in 1994, the Asian financial crisis of 1997, the demise of the world’s largest hedge fund LTCM whose incorporation offshore did not prove to be an issue although concerns were expressed that any bankruptcy of LTCM would have been complicated by its offshore status, the recent collapse of the two hedge Funds of Bear and Stearns, which triggered the 2008 credit crisis, and the Stanford scandal, confirm the role played by hedge funds in OFCs through

128 Ibid
130 Supra 124
IPI transactions, perhaps compromising the efficiency of financial markets. It may happen that a large, leveraged and, in the worst cause, insolvent offshore establishment, designed to escape the reach of supervisory authorities onshore, may disrupt the operation of its onshore affiliated bank. In other instances, offshore establishments may become substantially larger, in terms of assets and liabilities, than affiliated banks onshore. The exploitation by offshore banks of opportunities for regulatory arbitrage, may allow funds to be transferred funds can be used to finance connected onshore activities, concentrating onshore risks in inadequately supervised offshore financial centers. Often, OFCs provide opportunities for complex corporate structures and relationships among various jurisdictions designed to impede supervision. Shell companies” that serve as registers for transactions arranged and managed from other jurisdictions, can be used to exacerbate the already complex coordination problems arising in normal cross-border banking where two supervisory authorities are involved.

Territoriality and residence issues associated with the emergence of “brass-plate” companies, shell companies, international business companies (IBCs) and special purpose entities set up in OFCs, present further challenges for stability, as OFCs’ structure can complicate tracing the exact origin and location of IPI, channeled through them.131 These types of companies, whose residence is determined by virtue of their registration in OFCs, are significant points in cross border flows. The flexibility offered by OFCs complicates efforts to attribute investments to individual security holders, allowing funds to move under regulatory eyes. The significance of residence of hedge funds in OFCs lies in the impact of changes brought about in residence on the Balance of Payments accounting, where changing the registration of the companies to a different jurisdiction, alters the direction of capital flows even though no transaction of economic significance occurred.132 In addition, a change in the form of transactions channeled through these OFCs alters Balance of Payments measures, although perhaps with no real change in economic relationships. In other words, the cross border flows are recorded on the basis of the fund’s registration as a non-resident from the investment, even though a majority of holders in the fund could conceivably be located in the same country as the asset being acquired. Pooled investments allow savings from different country residences, blurring the OFC residence criteria, and negating assumptions that holders in the fund have the same country attribution. Custodians, insurance companies, fund’s managers, trusts, pension

131 Supra 7, 45-47
132 Supra 7, Nick Coates and Mike Rafferty
funds and mutual funds as collective investment schemes are often not aware of the nationality of the security holder they are investing on behalf of. Establishing the country attribution of a security issuer as well as finding the country attribution of a security holder becomes very problematic. Fierce competition for global financial business, on which OFCs depend, often raise concerns if the lower cost of financial services is achieved by lowering regulatory and supervisory standards. As OFCs provide financial services predominantly to nonresidents, the home countries’ authorities are concerned about the impact, on their national economies, of OFCs’ operations which are beyond their own country authorities’ control. In addition, the lack or absence of reliable data on activities of OFCs hampers analysis, making it difficult to assess the risk that OFCs pose to international financial stability. With the growing integration of financial markets worldwide, problems in a financial institution located in an OFC can be transferred rapidly to markets elsewhere. Such characteristics of OFCs and hedge funds raise concerns about their potential risks to international financial stability. Consolidated supervision of the total operations of the bank by the home supervisor, with adequate regulatory and supervisory standards applied in OFCs, seems the most reliable way to reduce such risks.

**Implications for Regulation: Regulation of Hedge Funds and Financial Stability**

Concerns about hedge funds and OFCs’ impact on financial stability have increased as their considerable growth and development exposed potential shortcomings leading to controversy about whether existing regulatory frameworks are adequate to safeguard financial stability and protect hedge funds investors, or whether new ad more stringent regulation is needed. The debate about whether direct regulation of hedge funds, and their investment advisers, or indirect regulation (market discipline) offer best regulatory options for the future, has resurfaced. It is suggested that market discipline failed as the breakdown of regulatory and supervisory systems contributed to the recent financial debacle. Market oversight failed to

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133 Is regulatory work the new fund formation for law firms? CLAIRE SMITH, the hedge fund journal, informing the hedge fund community, http://www.thehedgefundjournal.com/special-reports/hf-whos-who/is-regulatory-work-the-new-fund-formation-for-law-firms-.php


136 When dealing with externalities, we typically see direct regulation as the government explicitly limiting or supporting an activity based on the types of externalities it creates. So, in the case of pollution being a negative externality of creating electricity, the government may directly limit the amount of electricity that power plants are allowed to create in effort of limiting the impact of the negative externality. On the other hand, some of the positive externalities associated with education are higher income and more informed voters; this gives the government an incentive to directly regulate how much education each citizen should receive. Econ port: Direct regulation:

http://www.econport.org/content/handbook/Externalities/Dealing-With-Externalities/Public-Sector-Solutions/Direct-Regulation.html

stem excessive risk-taking or take into account the interconnectedness of the activities of regulated and non-regulated institutions and markets, perhaps due in part to fragmented regulatory structures and legal constraints on information sharing. The collapse of the two hedge funds of Bear Stearns, which fuelled the credit crisis of 2007,\textsuperscript{138} Lehman Brothers and AIG, demonstrated the failings of regulation and supervision of large and highly leveraged and substantially interconnected financial firms. Another example of market discipline’s weakness is when the investment banks were allowed to leverage their capital more than 30 times.\textsuperscript{139} In addition, the demand for more and stringent regulation of hedge funds is compounded by risks associated with the recent extension of its activities to retail investment, based on the “social security” argument,\textsuperscript{140} that regulation should protect the investing citizens’ interest, relying on standards that integrate integrity, transparency, and competence criteria. As a result, the rationale for keeping hedge funds outside regulatory scrutiny because they target only ‘high net worth’ individuals, is no longer valid. It is even suggested that the state jeopardizes its social security obligations when it fails to properly regulate hedge funds in which it invests.\textsuperscript{141} Regulators’ attention is, therefore, expected to increase.\textsuperscript{142} Recent proposals for the overhaul of financial regulation seek to address existing shortcomings and restructure the two pillars of regulation and supervision for an efficient and safe financial system.\textsuperscript{143} A well-balanced option combining elements of the direct and indirect approach seems to have gained flavor.\textsuperscript{144} However, regulating hedge funds and OFCs, has not been without its challenges.

The recent crisis has revealed the limits of current micro-prudential regulatory and supervisory approach characterized by weak financial institutions, inadequate bank regulation and supervision, and lack of transparency, and the assumption based on market fundamentalism, that in case of failures, financial institutions will always be bailed out.\textsuperscript{145} The assumption was that if bank supervisors ensured individual bank’s safety, systemic stability would look after

\textsuperscript{138} The Mortgage Reporter, Two former Bear Stearns Managers are indicted, June 19, 2008, http://www.mortgagefraud.org/journal/2008/6/19/two-former-bear-stearns-managers-are-in
\textsuperscript{139} Ibid 3
\textsuperscript{141} Ibid, 53
\textsuperscript{142} Interview James Norris talks to Gus Pope, managing partner of Maples and Calder, hedge fund journal http://www.thehedgefundjournal.com/special-reports/hf-whos-who/interview.php
\textsuperscript{143} Supra 114
itself. Regulation and supervision focused on individual financial institutions and neglected the systemic and international implications of financial markets participants’ actions. Market discipline relies on hedge fund investors, creditors, and counterparties to reward well-managed hedge funds and to reduce their exposure to risky, poorly managed funds. Indirect regulation works on the assumption that the capacity of hedge funds to adversely affect systemic stability derives from their relationships with other financial intermediaries which are regulated counterparties. There is, therefore, no need for a separate supervisory system for the hedge funds if supervisors of those intermediaries ensure that appropriate controls, such as oversight of the robustness of operational systems to exposures, and capital adequacy to cover risk in their interaction with hedge funds, are in place. Banks and other financial institutions are also sources of market discipline because they must perform credit assessments to rate a fund for its management, leverage, liquidity, and strategy, based on transparency, before providing financing or entering into derivatives transactions with hedge funds. These credit assessments should determine the amount of risk a bank will take when financing a hedge fund. However, this assumption that markets are self-correcting is challenged in the proposals for regulatory reforms for financial institutions, as false because in all cases the intervention of government saved the markets when they were in trouble, and that banks can behave in a way that collectively undermines the system. While markets are the best institutions for allocating private sector resources, their efficiency depends on rules that ensure the provision of sufficient information. But hedge funds are very reticent about sharing that kind of information, and are not usually required to do so by law as it is the responsibility of investors and counterparties to pressure them to improve their disclosures. Given that the contribution of hedge funds to market efficiency depends on their ability to generate and use proprietary information, any regulation compelling them to share that information limits their incentive to invest in information-gathering. Nevertheless, rules that ensure greater transparency and disclosure are desirable to the regulation of the funds as they help discipline the risk-taking activities of funds, and provide markets with information about potential risks. The challenges of regulating hedge funds activities, if only, by requiring them to provide more information about their positions, especially

146 Supra, 16
147 The international banking crisis of 1982, the bankruptcy of Continental Illinois in 1984, the failure of LTCM in 1998, AIG in 2008,
because of links with OFCs, should not, however, be underestimated. If hedge funds are required to publish more information on their activities, the responsibility of reporting frequently on the aggregate movements in hedge fund positions and the impact on efficiency and stability of setting reporting requirements for hedge funds should be assessed.

The disparate and dispersed nature of hedge funds regulation, at national and international level, is illustrative the ineffectiveness and weakness in the indirect approach. At present, there is no common regulatory regime for hedge funds in the EU, although a number of Member States have adopted national legislation. In London, requirements by the regulator (FSA), starting a hedge fund is so burdensome and requires details on everything about the firm's compliance systems to its risk controls together with an annual report that, once established, the regulator can only use a relatively light-touch approach based on broad principles. In the US, regulation of the hedge fund industry has always been difficult to enforce due to the dispersed and uncertain nature of the regulatory environment in which they operate. Over a seven-year period, starting in 1933, the United States reshaped the regulation of the market structures for banking, securities, derivatives, and mortgage and asset management through key pieces of legislation covering various financial sectors’ issues, including systemic stability, regulatory reorganization, transparency, enhancing market integrity, and reducing conflicts of interest. Hedge funds have always benefited from greater flexibility under the provisions of the National Securities Markets Improvement Act of 1996, which allowed investment companies to act without registration, if their investors were ‘qualified purchasers’, and from an exemption

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151 Supra 18, European Central Bank, Occasional Papers
153 1933, Glass-Seagall Act separated commercial from investment banking activities; 1933, Securities Act: Private funds typically avoid registration of their securities under the Securities Act of 1933 (Securities Act) by conducting private placements, established disclosure requirements for issuing securities on public securities markets and established prohibitions against securities fraud and manipulation; 1934, Securities Exchange Act created the Securities and Exchange Commission and authorized it for rule making and enforcement; 1935, (Omnibus) Banking Act reformed governance of the Federal Reserve and broadened its powers; 1936, Commodity Exchange Act increased federal prohibitions against fraud and expanded them to manipulation; 1940, Investment Company Act regulated companies that primarily invest in other companies such as mutual funds. including transactions between managers and any affiliate and set rules on corporate governance regarding executive management, board of directors, and trustees; private funds seek to qualify for one of two exceptions from registration; 1940, Investment Advisers Act required advisers to register, report, and keep records of their client relations. It also prohibited certain transactions and fee arrangements on the basis of conflict of interest, investment advisers who carry investment activities of private fund to private funds, often claim an exemption from registration under section 203(b) (3) of the Advisers Act, which is available to an adviser that has fewer than 15 clients and does not hold itself out generally to the public as an investment adviser.
154 SEC Supports Private Funds Transparency Act of 2009, July 20, 2009, Testimony Concerning Regulating Hedge Funds and Other Private Investment Pools; The SEC released a testimony from Andrew J. Donohue before the U.S. Senate about the regulation of hedge funds and other private investment pools.
from regulatory requirements for CPOs and CTAs offered only to highly accredited investors, most of which are persons investing in hedge funds.\textsuperscript{155}

The recent crisis has given rise to more voices for direct regulation of hedge funds and a substantially rule-based system.\textsuperscript{156} The new consensus that has emerged on the re-regulation of the financial system is grounded in the concept of “macro-prudential” regulation, the essence of which is that regulation should focus more on systemic risks instead of simply micro-supervision of individual banks. The perimeter of regulation needs to be expanded to encompass systemic institutions and markets that operate below regulatory and supervisory radar.\textsuperscript{157} The chief weapon in the macro-prudential armory is a capital regime for banks that curbs excessive credit growth.\textsuperscript{158} The challenge is to design new rules and institutions, at both the individual institution and macroeconomic level, that reduce systemic risks, improve financial intermediation, and properly adjust the perimeter of regulation and supervision, without imposing unnecessary burdens. Integrating the direct and indirect-“the gripper approach”\textsuperscript{159} hedge fund regulation has some merits whereby direct regulation would enable the consolidated exposure of the financial system vis-à-vis hedge funds to be highlighted by providing the necessary information to link any registered hedge fund with all of its brokers, relying on hedge funds’ registration bearing in mind their OFC links, and collection of structural data. Extending disclosure would provide supervisors with enough information to determine which institutions are big or interconnected enough to create systemic risk.\textsuperscript{160} On the other hand, indirect regulation would focus on systemic risk oversight directed primarily at the major banks providing funding, counterparty positions and transaction services to single hedge funds. The emphasis will be on monitoring counterparty risk management by prime brokers, including leverage ratios, and by looking after a sufficiently large capital base to cover the risks involved. Concerning funds domiciled in offshore centers, indirect regulation should factor in any risks emanating from counterparties not subject to direct

\textsuperscript{155} Initially required to register with the CFTC as “CPOs), and commodity trading advisors (CTAs), under the Commodity Exchange Act of 1936, in 1992; Susan C. Ervin, Letting Go: The CFTC Rethinks Managed Futures Regulation, 24 FUTURES & DERIVATIVES L.REP.1.n.5, 8 (May 2004).

\textsuperscript{156} Supra 141, deLarosiere report, Brussels, 2009.


\textsuperscript{158} The concept was also broadly endorsed by the de Larosière report to the European Union and in the Turner review in the UK. The effectiveness of macro-prudential regulation is a core assumption behind the capital proposals in last week’s US Treasury white paper on financial regulation.

\textsuperscript{159} Supra 140, Ben S. Bernanke, Financial regulation and the Invisible hand, April 2007, Speech at the NY University law School

oversight, a policy which will make the choice of offshore centers as the domicile for hedge funds less attractive.\textsuperscript{161} The central question remains, however, whether counterparty credit risk management, particularly by banks and securities firms, is sufficient to limit risk-taking of hedge funds and constrain systemic risk to socially efficient levels. Some have suggested that CCRM, as opposed to regulation, is the optimal way to control hedge fund leverage and limit systemic vulnerabilities\textsuperscript{162}

At the national level, the leading economies such as London, US and EU have unveiled hedge fund legislation in an attempt to reshape their patchy systems of financial services seeking to prevent a repeat of last year’s financial crisis.\textsuperscript{163} The European Commission has put forward an alternative investment directive that would force hedge funds and private equity firms to seek regulatory authorization, report their strategies and set aside capital against losses and to monitor and warn about threats to financial stability.\textsuperscript{164} The EU directive would impose stark restrictions on hedge funds as it is also feared that hedge funds’ short-selling destabilizes markets and opens avenues for market abuse.\textsuperscript{165} A new system of financial supervisors will oversee individual banks and financial firms, with supervision of firms remaining with national supervisors.\textsuperscript{166} The government of Germany, which is hostile towards hedge funds, placed hedge funds on the 2007 G8’s agenda,\textsuperscript{167} although the issue was never addressed by the G8. In the US, plans are moving forward to tighten the rules on everything from hedge funds and over-the-counter derivatives to mortgages and basic bank capital requirements.\textsuperscript{168} Supported by the establishment of a consumer financial protection agency to regulate mortgages, and hedge funds and hedge fund managers, the obligation to register with the SEC and open their books to examination, will considerably increase disclosure, giving regulators a powerful microscope to probe into the secretive hedge

\textsuperscript{161} Center for Financial Studies, White paper, No.II Feb, 2009, New Financial Order Recommendations by the Issing Committee Part II (March 2009)
\textsuperscript{162} Most recently, PWG (2007) concluded that “market discipline most effectively addresses the systemic risks posed by private pools of capital.”
\textsuperscript{163} The Private Funds Transparency Act of 2009 would address the regulatory gap discussed above by eliminating Section 203(b)(3)’s de minimis exemption from the Advisers Act, resulting in investment advisers to private funds being required to register with the Commission. Investment adviser registration would be beneficial to investors and our markets in a several
\textsuperscript{164} This will be a new body made up of central bank governors for all the member states in the 27-country bloc, and chaired by the president of the European Central Bank, which will also provide working support;
\textsuperscript{165} FT.com, Editorial comment: Government’s response like that of a rowdy drinker in a bar brawl, July 5, 2009, [http://www.ft.com/cms/s/0/5bc508ba-698c-11de-bc9f-00144feabdc0.html](http://www.ft.com/cms/s/0/5bc508ba-698c-11de-bc9f-00144feabdc0.html)
\textsuperscript{166} By Nikki Tait in Brussels Published: September 23 2009 13:23 | Last updated: September 23 2009 Brussels unveils regulation reform plan, [http://www.ft.com/cms/s/0/46d52e12-a834-11de-8305-00144feabdc0.html](http://www.ft.com/cms/s/0/46d52e12-a834-11de-8305-00144feabdc0.html); Two-tier approach suggested by former French central banker Jacques de Larosière in February after he was called to advise on changes in the wake of the recent financial and economic turmoil
\textsuperscript{167} Supra 142
fund industry and help identify potential systemic threats.\textsuperscript{169} It also aims to discourage excessive risk-taking among the biggest financial concerns and hedge funds found by regulators to be “so large, leveraged or interconnected that they pose a threat to financial stability” will be subject to more stringent requirements for capital, liquidity and risk management. The proposals constitutes a major departure from the laissez-faire’s focus on self-regulation of financial firms to one in which prudential measures aimed at improving the conduct of financial markets and addressing externalities that arise from large-scale risk taking,\textsuperscript{170} also prevents funds from moving offshore to escape registration.\textsuperscript{171}

However, the issue about regulation of hedge funds is not without controversy and the continued vehement opposition against regulation of hedge funds illustrates the complexity surrounding the issue. The involvement of several players in the game, including national governments, financial sectors, international organizations, complicate matters. The EU initiative to giving EU bodies any binding powers on supervision has not been without opposition. The German finance minister’s attempts to push for an agreement on tightening regulation of hedge funds were quickly opposed, mainly by the US and UK governments, and watered down to mere calls for disclosure. The Labor government is largely defending the tripartite system it set up more than a decade ago, which divides power among the Bank, the Treasury and the Financial Services Authority. Another argument against regulation has been the fear of increasing compliance burden, which “far outweigh any benefits”, building pressure from the views of institutional investor who are some of the biggest hedge funds customers, arguing that the proposed rules would be unworkable.\textsuperscript{172} The UK considers that the proposal is too intrusive and could trample on the independence of national supervisors, potentially harming parliament’s sovereign rights over the use of public funds.\textsuperscript{173} Concerns have also been expressed about the composition of the ESRC which should be independent from the ECB.\textsuperscript{174} Sweden’s opposition to EU regulation of hedge funds is based on an exaggerated fear that hedge funds contain big


\textsuperscript{172} Nikki Tait, Alarm at EU’s hedge fund rule plans, FT.com, June 15, 2009, http://www.ft.com/cms/s/0/550e7aa6-50db-11de-b687-00144feabdc0.html

\textsuperscript{173} Bertrand Benoit, Berlin to back EU financial regulation plan, FT.com, July 4, 2009, http://www.ft.com/cms/s/0/7e5b8d0-5094-11de-9350-00144feabdc0.html

\textsuperscript{174} George Parker, Myners wary of Brussels scrutiny plan, FT.com, June 3, 2009, http://www.ft.com/cms/s/0/4af224ea-506f-11de-9530-00144feabdc0.a01=1.html
systemic risks and would impose unnecessary compliance burdens. Criticisms are also based on opposition to regulation’s one-size fits all approach. In both the US and EU, policy makers argue that hedge funds were not central to the crisis but nevertheless welcome some minimal regulation aimed at protecting against the risks to the financial system.

The call for more stringent regulation of hedge funds and OFCs is fully backed by the international community who has spared no effort to move forward on an agenda aimed at a complete overhaul of the existing international regulatory and supervisory framework of financial institutions, combining both the direct and indirect approach. As of 2008, a variety of international institutions and intergovernmental committees already address issues of prudential financial oversight. Governments have also invested in designing rules and standards on the regulation of hedge funds and derivatives and often shared their conclusions with international bodies. The FSF’s work on areas relevant to the potential systemic risks associated with hedge funds and OFCs is based on its worries about newer risks, such as the rapid growth of derivatives and hedge funds in OFCs. The 2000 report provides an assessment of the financial stability issues and systemic risks posed by hedge funds and set out a range of recommendations to address the systemic risks posed by highly leveraged institutions, although it does not address the investor protection issues associated with institutional or retail investments in hedge funds. It monitors and reports on progress and actions taken in respect of

175 FT.com, Richard Milne, Fink warns on tough European restrictions, July 6, 2009
176 Tony Barber, Sweden rides to defence of hedge funds, FT.com, July 1, 2009,
177 FT.com, Nikki Tait, Alternative funds score EU victory, September 4, 2009
178 Progress Report on the Actions to Promote Financial Regulatory Reform, Issued by the U.S Chair of the Pittsburgh G-20, 25 September 2009, the FSF has been converted into a Financial Stability Board, among other changes, http://www.pittsburghsummit.gov/mediacenter/129639.htm
179 The most active have been committees or groups under the auspices of or associated with the Bank for International Settlements (BIS), especially the Basel Committee on Banking Supervision (BCBS). Supervision and regulation of securities and insurance have been discussed primarily in, respectively, the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). Cross-border accounting issues are the domain of the International Accounting Standards Board (IASB). The International Monetary Fund (IMF) and the World Bank have limited monitoring responsibilities in these areas. An umbrella organization created in 1999, the Financial Stability Forum (FSF), provides some oversight and coordination among the institutions and committees.
181 The FSF bringing together national authorities responsible for financial stability in significant international financial centers, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts, underscores the importance of ongoing cooperation among financial authorities in taking forward these recommendations and in spreading good practices.
182 1. Supervisors should act so that core intermediaries continue to strengthen their counterparty risk management practices; 2. Supervisors should work with core intermediaries to further improve their robustness to the potential erosion of market liquidity; 3. Supervisors should explore and evaluate the extent to which developing more systematic and consistent data on core intermediaries’ consolidated counterparty exposures to hedge funds would be an effective complement to existing supervisory efforts; 4. Counterparties and investors should act to strengthen the effectiveness of market discipline, including by obtaining accurate and timely portfolio valuations and risk information; 5. The global hedge fund industry should review and enhance existing sound practice benchmarks for hedge fund managers in the light of expectations for improved practices set out by the official and private sectors.
183 These reports are available at www.fsforum.org/publications/publication_21_25.html.
recommendations.\textsuperscript{185} The BCBS, probably the most prominent of the international public sector initiatives, issued, in 1999, a list of sound practices for banks’ interactions with “highly leveraged institutions” (HLIs). The Basel Committee on Banking Supervision recent\textsuperscript{186} proposals to raise capital requirements for certain complex structured credit products; to introduce additional capital charges for incremental risks in the trading book due to factors such as default, or changes in credit spread or in equity price; and to strengthen the capital treatment of liquidity facilities to off-balance-sheet conduits, provide viable options.\textsuperscript{187} Pillar 2 of the Basel II framework can be used by supervisors to strengthen risk management practices by banks, sharpen banks’ control of tail risks, and mitigate the buildup of excessive exposures and risk concentrations.\textsuperscript{188} The IOSCO\textsuperscript{189} technical committee has set forth recommendations for hedge fund regulation embodying a consistent global approach to addressing hedge fund risk through risk-based regulatory oversight of hedge funds, focused particularly on systemically important and higher risk hedge fund managers.\textsuperscript{190} As part of this regulation, hedge fund managers should provide information to help regulators protect investors and monitor systemic risk and risks to hedge fund counterparties.\textsuperscript{191} The G-20 Pittsburgh Summit Leaders’ Statement of September 2009, to completely overhaul the financial regulatory system for banks and other financial firms, seeking to improve risk management, strengthen transparency, promote market integrity, establish supervisory colleges, and reinforce international cooperation, raise capital standard, is perhaps the strongest signal sent by one of, if not, the most important international forum, responsible for international policy on financial stability issues, to address financial regulation at both national and international level.\textsuperscript{192} Against all odds that it would end up as a mere platform for countries and regions to win moral grounds on how to achieve regulatory reforms,\textsuperscript{193} it

\textsuperscript{185} G8 Summit 2007, Heiligendamm, Summit Declaration (7 June 2007) and In this context, we welcome the Financial Stability Forum’s (FSF) update of its 2000 Report on Highly Leveraged Institutions and support its recommendations.

\textsuperscript{186} BCBS, 2008b and 2008c

\textsuperscript{187} were issued by the Basel Committee in September 2008 (BCBS, 2008a).

\textsuperscript{188} Caruana and Narain 2008

\textsuperscript{189} International Organization of Securities Commission, \url{http://www.iosco.org/}

\textsuperscript{189} Supra 157, 11

\textsuperscript{190} IOSCO Recommends Hedge Fund Regulation as Part of Systemic Risk OversightJames Hamilton, J.D., LL.M April 17, 2009 CCS Financial Crisis News Center, \url{http://www.financialcrisisupdate.com/2009/04/iosco-recommends-hedge-fund-regulation-as-part-of-systemic-risk-oversight.html}

\textsuperscript{192} G20: Leaders’ Statement, Pittsburgh Summit, 24-25, 2009, Pittsburgh, 7-16, \url{http://www.pittsburghsummit.gov/mediacenter/129639.htm}

\textsuperscript{193} Viral Acharya Viral Acharya, Some steps in the right direction: A critical assessment of the de Larosiere report, VOX, 4 March 2009, \url{http://www.voxeu.org/index.php?q=node/3185}
succeeded to adopt “a very blunt, transparent, simple, and inflexible rule about how much capital all financial institutions need, of what specific type, and enforce it at an international level”. 194

Most of these initiatives recognize that it is very difficult to regulate hedge funds directly given the ease with which they can change their domicile with their operations based offshore, and avoid regulation. The potential risk posed by OFCs to financial systems have for some time been on the global agenda as part of the FSF195, IMF, FATF196, IOSCO, Basel, and OECD’s work, although some overlap exists on stability issues related to OFCs.197 The FSF’s report on OFCs indicate prudential and market integrity concerns stemming from factors in OFCs that impede effective supervision and impact on global financial stability.198 In response to concerns about instability linked with OFCs, associated with their overwhelming volume of activity, the IMF significantly stepped up its surveillance of OFCs in recent years to identify potential financial vulnerabilities, including those resulting from weak regulatory and supervisory systems.199 The IMF’s decision to integrate OFC assessment with the FSAP200 illustrates an attempt to strengthen regulation and supervision of OFCs and improve compliance with relevant international standards.201 International principles for banking regulation had already been set out by the Basel Accord in 1988 are based on the idea of “consolidated supervision” in which a bank's home supervisor took responsibility for monitoring the risks of the entire bank. This called for co-operation from host regulators as many OFCs fell far short of this requirement. The FATF drew up 40+9 standards202 for keeping money-launderers and terrorists out of the financial system, including a ban on shell banks and a requirement that jurisdictions must know the true owners of all companies set up within their borders. Both bodies decided, separately, that the way to prod OFCs into action was to name and shame them.203 Countries on these lists were

196 The Financial Action Task Force List of Non-Cooperative Countries (NCCTs) also know as FATF Blacklist, http://www.fatf-gafi.org/document/51/0,2340,en_32250379_3226020_34297139_1_1_1_1,00.html
198 Proposals for Improved Risk management, Transparency, and regulatory and Supervisory Reforms, Annex IV to the International Capital Markets 1999, September 24, 1999, prepared y a team under the supervision of Charles Adam, Donald Mathieson, and Gary schinasi.
http://www.economist.com/specialreports/displaystory.cfm?story id=E1_RGJVTJJ
201 IMF Executive Board Integrates the Offshore Financial Center Assessment Program with the FSAP, Public Information Notice, (PIN0 No.08/82, July 9, 2008, 1/5, http://www.imf.org/external/np/sec/pr/208/pm0882.htm
202 FATF International Standards against money laundering and the financing of terrorism, supra 192.
203 In 2000, the Financial Stability Forum (FSF) has put together a list of 42 jurisdictions that it defines as OFCs; the OECD in 2000 compiled a narrower list of 35 tax havens; and the FATF 23 “non-co-operative countries and territories”.
often barred from doing business with banks and other financial institutions in the rich world or made subject to much more onerous disclosure requirements. In the US, recent legislation\textsuperscript{204} was introduced in Congress as a result of pressures from the senators claiming that tax havens, small jurisdictions that draw offshore money through business-friendly rules and low (or no) taxes on non-resident business. The law will force states to identify the beneficial owners of corporations who have misused US corporations to hide illicit activity, including money laundering and tax fraud.\textsuperscript{205} OFCs have started to be lawmakers’ next target as illustrated by the recent agreement between the U.S. and Swiss governments over secret Swiss bank accounts held by U.S. citizens.\textsuperscript{206}

**Conclusion**

The recent credit crisis has brought to the surface of global agenda the issue hedge funds and Offshore Financial Centers as a result of concerns expressed about their implications for the stability of the international financial order. The recent growth and complexities associated with hedge funds’ activities through OFCs acting as hosts combined with the lax regulatory systems for both gave rise to such concerns. Concerns expressed about stability issues relate essentially to the absence of regulation and adequate supervision of both hedge funds and OFCs, which have the potential to lead to systemic risks spreading financial instability across regions. It is such concerns that have given rise to national and international efforts to improve the regulation of hedge funds and OFCs in an attempt to prevent future economic and financial calamities, relying on new approach moving to a more rule-based approach, combining market discipline. Whether these new regulatory proposals will achieve the required objectives remain an open-ended question although more in-depth analysis of the interaction between hedge funds and OFCs and their implications for regulatory design remain to be done.

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