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PANEL 3

HEDGE FUNDS, SOVEREIGN FUNDS, NEW SHAREHOLDERS, NEW RULES?

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HEDGE FUNDS ET FONDS SOUVERAINS, NOUVEAUX ACTIONNAIRES, NOUVELLES REGLES ?

Gérard Mestrallet
Chairman and CEO, Suez
Chairman, Paris Europlace

The year 2008 marks a turning point for international finance, for the structure of capital markets, and for the stability of the financial system in general. Since the creation of the euro nearly ten years ago, we have witnessed the challenge to the dollar as the major reserve currency, the arrival of new global financial players (in particular, hedge funds and sovereign funds), and the economic transformation of two giants, India and China, the latter having since become the third largest global economic power.

These changes also signal a new phase in the globalization of international finance, and offer new growth perspectives. However, the rising power of these new categories of market participants capable of dominating a significant share of market activity drastically changes the nature and traditional division of risk on a global scale.

As emphasized during the Europlace Forum in Tokyo last November by Christian Noyer, Governor of the Banque de France, globalization is strongly stimulated by the arrival of global financial players: major banks, hedge funds, venture capital funds, and, more recently, sovereign funds that share characteristics beneficial, in theory, to markets. They actively encourage market efficiency and provide liquidity to capital markets. They employ complex investment strategies. They implement sophisticated risk management techniques, which are then spread throughout different countries and markets. However, because of their size and their potential impact on market stability, these players are the target of sometimes hostile reactions from regulators and lawmakers, who demand greater transparency and question their influence – positive or negative – on financial stability.

How can we measure the real weight of these players?

A few numbers give an idea of the weight and importance of these players on the international financial scene:

- According to Morgan Stanley, sovereign funds at the end of 2007 had over $3,100 billion of investment capacity. Their role in international finance should grow significantly in the coming years, for at least two reasons: First, many countries such as Japan and India plan to create sovereign funds in 2008, and other countries plan to create sovereign funds in the next few years. Second, the continuing rise in the prices of raw materials, and the current account balance that favors major emerging countries, support the argument that sovereign funds will continue to develop in the years to come.

- Hedge funds, which are of a different nature, weigh more and more heavily on the international financial scene, with managed assets worth around $2,000 billion. Their management style is specific, with heavy use of derivatives and related structured products as well as tactical positions that tend to favor strategies employing significant leverage. Such strategies raise numerous issues and add to fears concerning the destabilization of markets that such active management might cause.

The Paris financial marketplace is prepared to accommodate the development of these activities.

Just as it did for American pension funds ten years ago, the Paris financial marketplace wishes to create a favorable environment for international sovereign funds. These sovereign funds are vital market participants. For many years, and even more so today, they have supported economies and companies in difficulty. Most of them take a long-term approach, and should be considered stable shareholders.

However, certain conditions must first be met concerning the public and private companies in which these new players invest, as well as the functioning of financial markets.

I. The Paris financial marketplace offers an attractive environment for hedge funds and sovereign funds.

The Paris financial marketplace has seen strong growth since the euro was introduced in 1999. Here are a few numbers that illustrate this growth:

- NYSE Euronext is now the world's biggest exchange in volume, with around €24,000 billion of capital exchanged, or more than the total capital exchanged on all the other European financial markets combined. The Paris branch of NYSE Euronext is the biggest stock market in Europe in volume, with nearly €3,300 billion of capital exchanged in 2007, ahead of London and Frankfurt.

- The Paris financial marketplace is first in Europe for international corporate bonds, with issues of over €200 billion, more than London (€180 billion) and Frankfurt (€80 billion).

- A global center for financial management, the Paris financial marketplace is second in Europe for asset management, with over €2,600 billion of assets under management, just behind London.

All of these factors draw to Paris a growing number of foreign investors who wish to develop their euro-denominated business activities. In 2006 alone, the Paris financial marketplace attracted over €30 billion of foreign capital.

The growth of our financial industry is our core concern, as illustrated by the creation of a high level committee (Haut Comité de Place), chaired by Mrs. Christine Lagarde, to promote the Paris financial marketplace worldwide and to increase the attractiveness of Paris as the financial center for euro markets.

Several priority items have been flagged for business development:

- to confirm Paris in its role as a research and financial innovation center, with the capacity to create and develop next-generation products in investment banking, insurance, and asset management;

- to strengthen and expand investment banking activity, particularly for derivatives, structured products, and project financing;

- to make Paris the preferred market of euro issuers and, more generally, the leading financial market for euro activities;

- to strengthen the asset management sector of the Paris financial marketplace, particularly in the development of alternative management and the accommodation of sovereign funds.

The attractiveness of the Paris financial marketplace for these players is twofold:

- First, the French asset management sector enjoys structural advantages, due mainly to a 15% savings rate in France (above the European average), leadership in UCITS management, and significant technical expertise in asset management and innovation. The French are among the global leaders in this sector, with five French groups in the top 25 asset managers worldwide. For sovereign funds wishing to establish operations in Europe, these different factors illustrate French expertise in management skills. This is the message that we have communicated to the sovereign funds we have met during our tours promoting the Paris financial marketplace in Norway, China, Korea, and the Persian Gulf.

- Second, many sovereign funds are attracted to the quality of French companies. For example, Dubaï International Capital now holds 3.1% of the European Aeronautic Defense and Space Company (EADS), or more recently the arrival of a Chinese sovereign funds in the capital of the French petroleum company Total. This attractiveness is useful for French companies that wish to develop business in emerging countries, because of the importance of having shareholders from the countries where they aim to develop.

Similarly, alternative investment management is a major sector within the French asset management industry where France is currently experiencing strong growth. The launch in 2005 of French vehicles for direct alternative investment management, called ARIA (lightly-regulated funds), and of guaranteed capital funds, has helped make the French environment more competitive. Assets under management of hedge fund products reached €43 billion at the end of June 2006, including €20.5 billion reported to the French market authority (Autorité des marchés financiers, AMF). Growth of this kind of asset management has been substantial, doubling over the last five years.

Growth in this segment is a priority for development of our activities in asset management, especially in the framework on the new Finance Innovation competitiveness cluster. In France, a large number of financial start-ups are focused on these activities, thanks to the high level of financial education in France and a local workforce with advanced technical skills, particularly in financial mathematics.

II. Nonetheless, a code of conduct must be implemented to satisfy expectations of companies and to ensure the proper functioning of the financial marketplace.

While the Paris financial marketplace clearly aims to attract global market players, it remains attentive to European and international debate about the potential risks of such activities. The importance of these market participants requires appropriate responses that aim to increase the transparency and good practices within these activities, both in the interest of the companies and of the Paris financial marketplace and its proper functioning.

From the point of view of financial players, and with potential risks taken into account, it is important to examine how banks can gain access to more thorough information on counterparties that use significant leverage, how guarantee policies consider the transparency and quality of counterparties, and how risky positions of complex products are valued. Another essential policy is effective surveillance, especially by the banking authorities, of relationships between hedge funds and their counterparties. As for sovereign funds, international dialogue on this subject is highly desirable.

From the point of view of listed companies in which the funds invest, and with specific reference to the work under way by the French employers' association (Mouvement des Entreprises de France, MEDEF), hedge funds have a positive impact on markets, including the following:

- **increased liquidity and market efficiency**, which allow companies to carry out financial transactions which might not be practicable with institutional investors;

- **a positive effect on corporate management**. The skills of hedge funds, based on knowledge of markets and companies and on a high level of technical expertise, have the positive effect of forcing companies to communicate more clearly their medium-term strategy.

At the same time, a number of criticisms can be made:

- **The impact on price volatility**. Very specific investment strategies, based on performance criteria that are not correlated to financial market movements, have a definite influence on price volatility. The aggressive tactics of certain funds can also contribute to greater price volatility at any given moment.

- **The effects of concerted actions** aiming for short-term profit can be detrimental and destabilizing to companies.

- **The existence of conflicting interests** is very obvious in hedge funds, since their influence goes well beyond the context of the company, and can affect entire sectors.

- **The use of leverage to increase the size of portfolios can also lead to negative consequences**. Hedge funds are able to benefit from leverage either directly (by borrowing from prime brokers) or indirectly (using derivative products), and are especially vulnerable to a sudden decline in market liquidity.

The recommendations are focused on the following actions:

- to improve the transparency of a hedge fund's investment in a given company by requiring prior announcement of an interest in the company concerned to the General Meeting. This effort should be carried out on a European level, via the Committee of European Securities Regulators (CESR).

- to improve available information on markets where hedge funds operate. The credit derivatives market is a very relevant example, in that the implementation of a "data warehouse" would probably provide precious information for financial stability.

The MEDEF has provided recommendations that also concern companies in which hedge funds might invest. It should aim:

- to value stock prices correctly (clarification of medium-term and financial strategies);

- to instigate and build stable and lasting dialogue with shareholders in order to ensure their support for votes at the General Meeting;

- to analyze shareholder structure, with the fundamental goal of strengthening the share of long-term investors in the capital structure, as a real counterbalance against the effects of mass behavior and price volatility;

- to identify its interlocutors (nature of the fund, objectives, intentions, etc.).

The rules and norms of functioning must be discussed on a European and international level, involving the various parties concerned by these questions.

This is why the Paris financial marketplace fully supports the reasoning of the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) in developing working relations with sovereign funds with the aim of developing best practices of fund governance, which would include vital questions addressing the structure of governance, risk management, transparency, the publication of financial information, etc. The definition of good behavior will contribute to the efficient inclusion of sovereign funds in the international financial context.

In this context, it is now up to Europe to participate in all international debates, promoting the point of view of European financial market users on these crucial questions concerning the stability and proper functioning of European and international markets.