31st Annual Conference of
The International Organization of Securities Commissions (IOSCO)

8th June 2006
Hong Kong

Panel 2: Hedge Funds – How Far is it Necessary to Regulate?

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Good morning Ladies and Gentlemen and thank you to IOSCO for inviting me to speak here today.

Hedge funds have been a significant item on our agenda for some time now reflecting the strong growth of London as a major centre of hedge fund manager activity. In addition prime brokerage has become very big business for the investment banks. The figures are very impressive, in March 2006 Eurohedge estimated that FSA authorised firms manage at least $256bn or over three quarters of hedge fund assets managed by European based firms. This is around 17% of global hedge fund assets.

We publicly acknowledge that hedge funds are a major source of market liquidity; they significantly enhance market efficiency and offer access to a range of investment techniques for increasing portfolio diversification. We are committed to playing our part to ensure the UK remains an attractive location for hedge fund managers to be based.

But what are the risks the FSA sees the hedge industry posing to its four statutory objectives, how has the FSA responded to these risks and what are the areas where we consider further work is required? This morning I aim to briefly address each of these questions.

1. <u>An outline of Hedge Fund risks in general</u>

Our risk-based approach to supervision applies proportionate resources to firms on the basis of the risks they pose to our four statutory objectives of Market Confidence, Consumer Understanding, Consumer Protection and the Reduction of Financial Crime. The sophisticated investor base of the industry means we place less emphasis on the Consumer Protection and Consumer Understanding objectives than in the Retail Asset Management industry. The following are some of the key potential risks we have identified; although, to be clear, identifying a risk does not say anything about the probability of the risk crystallising.

Serious market disruption and erosion of confidence - The failure or significant distress of a large and highly exposed hedge fund – or, with greater probability, a cluster of medium sized hedge funds with significant and concentrated exposures – could cause serious market disruption. It could also erode confidence in the financial strength of other hedge funds or of firms which are counterparties to hedge funds.

Liquidity disruption leading to disorderly markets - The incidence of hedge funds collectively making concentrated investments in complex specialist financial instruments and particular market segments (usually on a leveraged basis) is increasing. Coupled with the increasing sensitivity of their investor base to performance, this can engender a significant liquidity mismatch leading to enforced asset disposals and consequently volatile and potentially disorderly markets.

Market abuse / insider trading and manipulation – We believe some hedge funds maybe testing the boundaries of acceptable practice with respect to insider trading and market manipulation. In addition, given their payment of significant commissions and close relations with counterparties, they may create incentives for others to commit market abuse.

Insufficient information to inform regulatory action - Partly because of issues of extra territoriality, regulators may have insufficient reliable and comparable data on which to base informed decisions about risk and consequently proportionate regulatory action to mitigate that risk.

Control and Operational issues - Reflecting their trading (rather than management) background and their typical ownership structures, some hedge fund managers do not have the optimal skill set or incentives to create an effective control and operational infrastructure. Unsurprisingly, the recent rapid growth of the sector has been challenging for some hedge fund managers, with problems such as late trade confirmations, non-notified trade assignments and novations adding significantly to market-wide operational and credit risk levels.

Valuation weaknesses - Weaknesses in asset valuation methodologies and processes related to skill shortages and conflicts of interest are creating significant potential for ill-informed investment decisions and detriment to market confidence. Incentive structures, light regulatory oversight and weaker control environments increases the likelihood that hedge fund managers will commit fraud by issuing false valuations.

Retailisation – Penetration of the retail market by hedge fund investment techniques (referred to here as 'retailisation') poses the risk that consumers do not understand, and firms do not adequately manage, the different risk characteristics of funds or products with hedge fund characteristics that are now entering the retail market (for example, UCITS III funds, structured products and funds of hedge funds with lower minimum investment levels).

Preferential treatment of investors – Some hedge funds are issuing undisclosed side letters which offer enhanced liquidity and other preferential benefits to selected investors, to the potential detriment of other investors in the fund.

2. How the FSA has responded

I must start by emphasising the FSA is **not** seeking to authorise and regulate the funds. Also, it is important to note that the FSA does not have a "no failure" objective. We expect that some funds will go out of business and indeed we believe this is a prerequisite for a healthy marketplace. Nevertheless, we believe that we can mitigate the risks through effective supervision of hedge fund managers and broker/dealers who provide prime brokerage services to the funds.

The FSA set up a centre of hedge fund expertise in October 2005. In line with our risk based approach, it is imperative that we use this resource efficiently and effectively to fulfil our statutory objectives. Therefore, a priority of this team will be to increase our supervisory oversight of 25 of the largest hedge fund managers in the UK. These managers will have a dedicated supervisor who they will be in regular contact with. The firm, in FSA terms is relationship managed. In identifying these 25 ‘higher impact’ managers, we believe we will be able to better monitor developments in the industry as a whole, as well as assessing the risks posed to our statutory objectives by these individual firms. The FSA undertakes periodic risk assessment of relationship managed firms and develops individual risk mitigation plans with them.

Lower impact, non relationship managed firms are also supervised but in a different way. They are subject to baseline monitoring through regulatory returns and other types of alerts. The centre of expertise advise, assist and occasionally take the lead on the FSA response to complex cases in conjunction with the wholesale investment firms case team where an alert is generated with respect to a specific issue at a specialist hedge fund manager that is not relationship managed. Furthermore the team undertakes thematic supervision, covering a wide range of entities that have hedge fund mandates irrespective of where within the FSA that group or firm is supervised – the approach is designed to address the risks posed by the industry as a whole.

The FSA will continue to maintain an ongoing non-supervisory dialogue and where possible, work with the industry. For example in 2004 the FSA (Wholesale Investment Banks Department), in collaboration with firms and the London Investment Bankers Association (LIBA), established a regular six-monthly survey of the exposures to hedge funds of the London based banks that provide prime brokerage services. The FSA also strongly supports the involvement and work of IOSCO on valuations.

On the international side, the FSA aims to enhance dialogue with other international regulators, in particular about issues that typically arise offshore such as issues in relation to valuation and anti money laundering arrangements.

Market Integrity

We believe that hedge fund managers need to be vigilant around their compliance with Principle 5 of our Principles for Businesses (a firm must observe proper standards of market conduct) and in particular the market abuse aspect. This is due to their tendency for high portfolio turnover and the consequent high commission generation. This includes compliance with the Code of Market Conduct (COMC) (MAR Chapter in the Handbook) and the Market Abuse Directive. It is important that the systems and controls are adequate to deal not just with dealing with market sensitive information but also to ensure they don’t fall foul of the criminal or civil offences.

It is important for managers to ensure they have adequate systems and procedures for dealing with market sensitive information so that they can deal with any inquiries that may follow from alerts about potential misconduct.

We are currently making revisions to our existing transaction reporting system, the Surveillance Analysis of Business Reporting System (SABRE). When the revised SABRE is introduced, amongst other improvements, it will have a more sophisticated analytical capability for identifying potential market abuse.

Market disruption/systemic issues

In 2004 we established a regular six monthly survey on the exposures to hedge funds of the London based banks that provide prime brokerage services. The aim of this survey is to enhance our understanding of prime brokerage and to gather data on the exposures of the firms to major hedge funds, either via prime brokerage or via the trading of OTC derivatives.

The survey targets the largest Prime Brokers (10-15 firms) with 2 main data requests; the first looks at their credit exposures to hedge funds (largely OTC derivatives, secured lending), the second focuses on the prime broker business (size and leverage of largest hedge fund clients, collateral coverage, fund strategy mix).

The survey is a successful collaboration between the FSA, the firms, and London Investment Bankers Association (LIBA), involving survey template negotiation and a voluntary disclosure of hedge fund exposures. The quantitative benefits of the survey have worked in tandem with qualitative support; it has advanced supervisory discourse with firms, particularly those with large risk exposures. Along with further qualitative work in collateral and margin arrangements, the survey represents a proportionate and effective response to growth in the hedge fund industry.

The FSA is also undertaking further qualitative work with the banks on collateral and margin arrangements.

Disclosure to regulators – data from managers

Once we have identified a manager who uses hedge fund techniques – we will collect a modest amount of extra data from them on the service providers the funds that they manage use, namely

- Prime Broker (and custodian if separate);
- third party Administrator; and
- the fund Auditor.

It is important to emphasize, we will collect this data for each manager not for each fund.

This will distinguish prime brokers more clearly, including entrants who may be following less stringent risk management standards in the pursuit of market share and hence posing a risk to our market confidence objective. We do not authorise the third party Administrators who for the most part are based outside the UK so we cannot ask them which funds they provide services to. In the case of the audit question, we would ask this to ensure they are members of recognised professional bodies and have sufficient experience, given that frequently they are the only independent oversight of valuations (in contrast to authorised Collective Investment Schemes which have a depositary or Trustee).

3. Unresolved issues

Mis-valuation of complex illiquid instruments/fraud

The difficulty of valuing positions in illiquid assets and markets or in circumstances where no independent, objectively verifiable, screen prices are available – are areas of particular risk in this sector.

Hedge fund managers should ensure they maintain appropriate systems and controls to address risks arising from valuing positions, particularly where managers provide valuations of instruments to administrators.

Conflicts of interest arise, as the remuneration of the manager through performance fees creates strong incentives to overstate valuations or smooth the volatility of their pricing. In particular where performance has been poor, the pressure on managers to provide overstated valuations is greatest (often in the hope that performance will improve so the overstatement will eventually no longer be necessary). Fund auditors only check valuation procedures annually; this can allow errors to run unchecked for too long. In addition, administrators may not be sufficiently technically strong to challenge these valuations effectively.

There is potential for these problems to extend beyond issues of market quality to fraud and other forms of financial crime. Incorrect valuation could lead to investor detriment either through the manager charging performance fees on profits that have not been generated. Or it could allow some clients to realise their investments at an advantageous price, creating a dilution of value be borne by the residual investors.

Internationally, we have been at the forefront of work among regulators on the issue of valuations. We also strongly support the work of IOSCO on the valuation issue. IOSCO SC5 has mandate (with input from IOSCO SC3) to complete a project on hedge fund valuations this year.

This project aims to:

- examine the policies and procedures employed by hedge funds and their counterparties in the valuation of their assets, liabilities and investors interests (including any regulatory requirements with particular reference to industry codes to which they may adhere);
- identify any issues of concern to regulators; and
- working closely with industry representatives, develop a single, global set of principles relating to the valuation of hedge fund assets and liabilities, that will attract global consensus.

Transparency/ side letters

A hedge fund manager should assure that potential investors receive material and relevant information sufficient to enable them to make an informed investment decision. Such material is likely to include information about arrangements with other investors such as side-letters that would materially disadvantage the potential investor. We believe that failure by UK based hedge fund managers, to make adequate disclosures is, amongst other potential breaches a breach of Principle 1 of our Principles for Businesses ('a firm must conduct its business with integrity'). If needs be, we will take action against firms for breaches of the Principles on that basis. The Principles are a statement of firms' fundamental obligations. They apply to all firms and this includes hedge fund managers. The consequences of a firm breaching one or more Principles and how we determine whether a Principle has been broken are made clear in our Handbook.

In the case of side letters, we believe that a number of hedge fund managers may, influenced by the commercial attractiveness of large-scale investments from strategic investors, be agreeing side letters. Or where they are not actually parties to the letters themselves, at least playing some active role in relation to their negotiation. This may be to the detriment of other investors in the same share class in the hedge fund who should be aware that side letters can affect the risk profile of their hedge fund investment. A lack of transparency and disclosure about side letters deprives these other investors of access to comprehensive information. Consequently, this is to their detriment compared with significant investors in the fund who receive more favourable treatment. As a minimum we would expect acceptable market practice to be for managers to ensure that all investors are informed when a material side letter is granted.

We will undertake a review of a sample of firms' practices in this area later in the year. That work will inform our policy thinking and enable us to take action against individual firms and their senior management if appropriate. Investors need to consider the existence of side letters carefully in their due diligence.

Conclusion

This morning I have briefly covered the risks the FSA sees the hedge industry posing to its four statutory objectives, how has the FSA responded to these risks and what are the areas where we consider further work is required.

Finally, I believe the best way the FSA can achieve its objectives in these areas by being a regulator that:

- has open dialogue with the sector and works in partnership with it;
- only intervenes from necessity where there is a clear market failure and the benefits exceed the costs;
- focuses on the biggest risks; and
- uses limited resources to effectively deal with those risks.

I hope from the approach outlined above we are well on our way to achieving that.