Topic 4: Development of Institutional Investors and Regulation of Private Equities and Hedge Funds

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Interactive discussion: Question 1 – Fernando Restoy and Howard Wetston

Question 1

As the capital markets in mainland China become more developed, different investment opportunities and strategies, such as hedge funds and private equities, will become available. While the hedge fund sector offers the advantage of a larger range of product choices to investors, and the trading activities of hedge funds may add to market liquidity, there are concerns in the global marketplace about the impact of hedge fund participation on financial stability risk. How are regulators responding to the regulation of hedge funds? What are the lessons that the Mainland could learn from the more developed markets?

(3-4 minutes each)

SPEAKING NOTES

Regulation of hedge funds

The financial crisis has focused attention on systemic risk and financial stability. While hedge funds may have been caught up in the financial crisis, they didn't cause it. There is no conclusive evidence to suggest that hedge funds pose any systemic risk.

However, there are some features of hedge funds that can lead to concerns about their potential to create or, at least, propagate, systemic risk. These features include:

1) the ability to take on leverage via borrowing and/or derivative transactions

2) a wide array of interconnections including prime broker arrangements and other counterparties (e.g. the counterparty to bilateral derivative contracts)

3) an active trading role, and

4) the ability to concentrate their assets in a relatively small group of investments.

The size of the global hedge fund market has grown significantly over the past decade. By March 2012, assets under management (AUM) were US $2.13 trillion. Given its size, it is reasonable to expect that hedge funds can have a significant impact on other financial sector players (e.g. prime brokers, dealers, banks, insurance companies who are counterparties to hedge funds).

While hedge funds have a significant presence in the global marketplace, Canadian hedge funds are relatively small. Based on a 2010 IOSCO coordinated survey, the funds' total assets under management was less than 2% of the total Canadian mutual fund assets and represented less than 1% of the global hedge fund industry. The survey also indicated that Canadian hedge funds do not employ high level of leverage or complex trading strategies.

That being said, consistent with international standards, Canada has a regulatory framework for oversight of hedge fund managers.

We have a national rule (NI 31-103 *Registration Requirements*), which came into force in September 2009, that requires the registration of investment fund managers, including hedge fund managers.

A hedge fund manager directs the business, operations or affairs of a hedge fund. As registrants, hedge fund managers are subject to our oversight. They must comply with the rules and on-going regulatory requirements, which include, for example, establishing an effective compliance system, managing conflicts, maintaining adequate working capital and insurance, and keeping adequate books and records.

In addition to the requirements that are imposed on the industry by the regulators, the hedge fund industry itself has also undertaken certain initiatives to provide guidance in the areas of risk management practices and disclosure. This is a positive direction for the hedge fund industry.

Data collection by regulators to monitor the hedge fund industry

It is important for regulators to continue to increase their knowledge of hedge funds and their activities. Regulators have taken steps to increase their collection of information on hedge funds by either conducting surveys of hedge fund managers or requiring the periodic reporting of information.

Canadian regulators participated in the 2010 IOSCO coordinated survey. This was a data-gathering initiative to collect information from hedge fund managers to assist in assessing the systemic risks that hedge funds may pose.

We will participate in the second IOSCO survey that will be conducted in the fall of 2012. The second survey will include a larger sample size and it is expected to provide more information about the global hedge fund industry.

Beginning in June 2012, the SEC will require the filing of an annual form that will be used to collect data on many aspects of the hedge funds such as size, leverage, liquidity, investment strategy, counterparty risk, exposure and concentration. The data will assist in assessing and monitoring for potential systematic risk.

The UK FSA has also undertaken to survey managers of hedge funds on a periodic basis to monitor trends in hedge funds as they relate to systematic risk. They support a

coordinated data collection approach.

Lessons China could learn from more development markets

One important lesson that we could all learn from recent experience is that it is important to remain aware of how financial markets, whether it be hedge funds, OTC derivatives or other areas, are developing.

During the financial crisis, developed markets learned how challenging it could be to understand markets in the midst of financial stress. This experience led to IOSCO's adoption of new Principles 6 and 7 two years ago.

- Principal 6: The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate.

- Principal 7: The Regulator should have or contribute to a process to review the perimeter of regulation regularly.

As regulators, we must remain cognizant of the changing financial sector and proactively address emerging risks that may threaten the safety and confidence of our financial markets.

It is important for regulators to work together to monitor risks on a global basis and to increase their knowledge of hedge funds and their activities. This is evident in the collaborative work undertaken by IOSCO, particularly the collection of information from the hedge fund managers via the coordinated survey.

Hedge funds are liquidity providers in the markets they are active in. They also contribute to the efficient allocation of capital and portfolio diversification. From an investor’s perspective, hedge funds offer a variety of investment strategies.

However, hedge funds may not be an appropriate investment for everyone and regulators should be aware of the state of their industry.

In terms of hedge fund regulation, we believe that regulators should take a pragmatic and balanced approach.

In the past, hedge funds were not subject to registration and oversight in many jurisdictions. Regulators have addressed this by either requiring registration of the investment advisers or the hedge fund managers or both. Regulators have also increased the collection of information on hedge funds for the purpose of understanding and monitoring their activities and trends.

This increased knowledge and information will assist regulators in the development of appropriate regulation for the hedge fund industry.