Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds

Report of the Technical Committee of the International Organization of Securities Commissions

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Introduction

During its meeting in 17 and 18 February 2003 meeting the IOSCO Technical Committee approved for public release the report entitled *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds*. Work on this project was initiated in May 2002 when the Technical Committee mandated its Standing Committee on Investment Management (SC5) to look into the regulatory issues arising from participation by retail investors in hedge funds.[1] This IOSCO Technical Committee report identifies specific regulatory issues created by hedge funds and details approaches for addressing the impact these issues have on retail investors.[2]

The backdrop for this paper begins with the many studies and reports undertaken on the subject of hedge funds and the risks posed by uncontrolled leverage, especially in light of the collapse of Long Term Capital Management in 1998. Most of that work, however, concentrated on the possible systemic effects of hedge funds that possessed a certain level of assets and that were leveraged to an extent that would affect adversely regulated markets. In order to differentiate these funds from the majority of hedge funds that were neither large nor highly leveraged, these funds were described as Highly Leveraged Institutions (HLIs). Direct and indirect retail participation in HLIs was relatively small and it was felt that the large sophisticated or institutional investors in those funds were capable of protecting their own interests. It now appears that hedge funds and similar vehicles, especially funds-of-hedge-funds, are increasingly targeting and attracting retail investment.

In late 2001, SC5 updated a brief questionnaire on the extent of retail participation in hedge funds in the jurisdictions represented on SC5. The results of the questionnaire suggested that there was growing retail participation in highly leveraged instruments, including those offered by hedge funds, if not directly, then through fund-of-hedge-funds type vehicles. It was observed that, in many jurisdictions, while direct retail participation in a hedge fund is prohibited unless the fund complies with all of the normal regulatory restrictions on collective investment schemes ("CISs"), in some jurisdictions, CISs are permitted to invest in funds which in turn invest in hedge funds.

The increased participation of retail investors in hedge funds and fund-of-hedge-funds raises various regulatory issues especially related to investor protection issues. Although the terms 'retail participation,' 'retail investors,' and 'retail investment' vary by jurisdiction, it is well-

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[1] As discussed below in this paper, it is very difficult to come up with a satisfactory definition of the term 'hedge funds.' Nonetheless, over time, the term has referred consistently to an investment vehicle that pools the monetary contributions of multiple investors and employs a variety of investment strategies. For the purposes of this paper, only the term 'hedge funds' has been used, although similar considerations apply to other funds which are not regulated.

[2] As of the last quarter of 2001, it was estimated that there were between 4,000-5,000 hedge funds that managed $400-$500 billion in capital. See The Financial Stability Forum ("FSF"), *Recommendations and Concerns Raised by Highly Leveraged Institutions: An Assessment*, March 2002, at 1-2 (http://www.fsforum.org/Reports/HLIreviewMar02.pdf). The amount of this pool that is contributed by retail investors is not clear.

accepted in regulatory circles that these terms refer to investors other than those normally referred to as 'professional,' 'qualified' or 'sophisticated' investors.[3]

A project in this area was therefore considered useful for the following reasons:

- There may be particular risks that need to be disclosed to retail investors about their investment in these vehicles;
- Existing regulation (or exemptions from regulation) may be based on premises that need to be tested or may no longer be correct, e.g., that retail investment is not permitted;
- The existing regulation of the extent to which CISs may invest in derivatives or use certain trading techniques, such as short selling, may need reassessment; and
- Significant investment by CISs in highly leveraged instruments raises questions about the CISs' internal controls and processes for managing the risks posed by those investments.

This paper is exclusively concerned with retail investor protection issues and does not treat questions relating to such matters as systemic risk and exposure to hedge funds by banks and investment firms. Furthermore, parts of this paper focus primarily on hedge funds as they determine the underlying issues for funds-of-hedge-funds.

Regulatory issues raised by the existence of hedge funds

Several issues can be identified:

- What are hedge funds and can they be sufficiently identified in legal terms to enable specific regulation?
- Are hedge funds by their very nature riskier for retail investors than 'normal' funds, and, if so, is this a bad thing?
- If direct investment in hedge funds is not open for retail investors, should it be open indirectly in the form of funds-of-hedge-funds?
- Should hedge funds, including funds-of-hedge-funds, be subject to the same rules as more traditional CISs?
- Should special authorization and supervision requirements be imposed on hedge funds with retail investor participation with regard to organizational aspects, taking into account the investment strategy, the expertise required for management, management information, technology and the appropriate internal controls?
- Are there additional disclosure requirements that need to be placed on hedge fund in order to make their risk profiles and strategies comprehensible to retail investors?
- Do regulators have sufficient expertise in-house in order effectively to authorize and supervise complex hedge funds?

Scope of the types of CISs involved

Before entering into a discussion of the regulatory aspects of retail investment in hedge funds, it is necessary to attempt, at least broadly, to arrive at an adequate description of such

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[3] Some jurisdictions define a retail investor by reference to their income or net worth. For example, in the US, retail investors are those who do not meet the "accredited investor" standard of either (1) income of US$200,000 for the last 2 years and a reasonable expectation of making at least this in the current or coming year or (2) net worth of US$1 million.

funds. As a premise it is assumed that a hedge fund will always be a vehicle for collective investment. A hedge fund is not the normal-type CIS that is open-ended and invests primarily in listed securities, whilst being conservative in its use of derivatives. "Funds-of-hedge-funds" refer to CISs that invest primarily in a number of underlying hedge funds, which may or may not be affiliated to the manager of the fund-of-funds.

In the 1999 IOSCO Technical Committee report on *Hedge Funds and Other Highly Leveraged Institutions*, HLIs were, for the purposes of that report, described as, "…institutions which are significant traders for their own account in financial instruments and which display some combination of the following characteristics:

- they take on significant leverage;
- they are subject to little or no direct prudential regulation; and
- they are subject to limited disclosure requirements as they are seldom public companies."[4]

This description does not appear to be useful for the purposes of this paper. Firstly, the scope of the previous IOSCO work focused only on that small subset of funds that potentially posed market stability issues. Secondly, not only hedge funds, but other CISs (or their management companies) also trade in financial instruments for their own account. Thirdly, most hedge funds do not use significant leverage.

An approach for identifying hedge funds is to look at the kinds of characteristics of and strategies employed by institutions that would consider themselves to be hedge funds. Hedge funds have at least some of the following characteristics:

- borrowing and leverage restrictions, which are typically included in CIS regulation, are not applied, and many (but not all) hedge funds use high levels of leverage;
- significant performance fees (often in the form of a percentage of profits) are paid to the manager in addition to an annual management fee;
- investors are typically permitted to redeem their interests periodically, e.g., quarterly, semi-annually or annually;
- often significant 'own' funds are invested by manager;
- derivatives are used, often for speculative purposes, and there is an ability to short sell securities;
- more diverse risks or complex underlying products are involved.

The distinguishing characteristics of hedge funds are not limited to this and the (near) future could result in this list needing to be adapted to take account of market dynamics.

The investment strategies tend to be quite different from those followed by 'traditional' asset managers. Furthermore, these strategies do not fit within neat definitional categories because each fund usually follows its own proprietary strategies. In a recent discussion paper, the Financial Services Authority of the United Kingdom – after having mentioned the foregoing – lists the following three most common broad fund types:[5]

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[4] IOSCO Technical Committee, *Hedge Funds and Other Highly Leveraged Institutions*, November 1999, page 4.
[5] UK Financial Services Authority, Discussion Paper 16: *Hedge Funds and the FSA*, August 2002.

- Event driven funds investing in securities to take advantage of price movements generated by corporate events. This group includes merger arbitrage funds and distressed asset funds.
- Global macro funds that take long and short positions in major financial markets based on views influenced by economic trends and events.
- Market neutral funds where the manager attempts to minimize (or significantly reduce) market risk. This category includes long/short equity funds, convertible bond arbitrage funds, and fixed income arbitrage.

On the basis of the foregoing descriptions, it will be possible to identify a CIS as being a hedge fund in the broad sense of the term. This is a fairly pragmatic approach that is, for instance, followed by the Securities and Futures Commission (SFC) of Hong Kong. Section 8.7 of the SFC Code on Unit Trusts and Mutual Funds states: "The following criteria apply to collective investment schemes that are commonly known as hedge funds (or alternative investment funds or absolute return funds). Hedge funds are generally regarded as non-traditional funds that possess different characteristics and utilize different investment strategies from traditional funds. In considering an application for authorization, the Commission will, among other things, consider the following: (i) the choice of class of assets; and (ii) the use of alternative investment strategies such as long/short exposures, leverage and/or hedging and arbitrage techniques."[6]

Given the broad range of investment instruments and economic and financial objectives employed by hedge funds, such a pragmatic approach assists the identification of such funds for regulatory purposes. Nevertheless, it will, at the end of the day, most likely be next to impossible to arrive at a definition of 'hedge funds' that is a) accepted internationally and b) sufficiently precise for 'universal' implementation in laws and statutes regulating CISs.

Existing regulatory regimes for hedge funds

In 1999, SC5 conducted a survey among its members with regard to the regulatory environment for hedge funds in the various jurisdictions. This survey was updated in late 2001.

The following observations can be made on the basis of the survey:

- Most jurisdictions consider hedge funds to be CISs. In a few jurisdictions, hedge funds do not fall under the concept of collective investment due to their legal structure.
- There appear to be three types of regulatory starting points. Hedge funds:
    1. are prohibited outright;
    2. fall within the scope of the general regulatory framework for CISs; nevertheless, hedge funds often profit from exclusions or exemptions from the applicability of the general framework when they are, for example, open only to professional/qualified investors;
    3. are not considered to be a CIS and are therefore not prohibited from being offered.

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[6] The Swiss Federal Banking Commission also applies a pragmatic approach through a licensing procedure for 'funds with special risk.' This qualification is not based on economic factors such as volatility, but on the legally binding investment policy as laid down in the prospectus. The Central Bank of Ireland has recently introduced a regime for the authorisation of 'funds of unregulated funds' which invest more than 10% of their assets in entities such as hedge funds and alternative investment funds.

- There is no common definition for hedge funds.
- Compared to the 1999 survey, hedge funds seem to be more available in different jurisdictions (either directly or, which is the predominant case, indirectly via funds-of-funds) for retail investors. The changes do not appear to be specifically aimed at hedge funds, but result from relaxation of regulation in the field of funds-of-funds, investment restrictions, the use of derivatives and short-selling techniques.
- In those jurisdictions that allow (funds-of-) hedge funds, very few ‘pure’ hedge funds exist that fall under the supervisory framework for CISs and that attract investment from the general investor public. Investment in ‘pure’ hedge funds is mostly restricted to sophisticated or professional investors. The funds-of-hedge-funds, however, are not necessarily restricted to such investors.
- Statistics are few and far between. Some jurisdictions have data, but because of the lack of a common definition, it was not possible to make a reliable estimate of the size of the (retail or non-retail) investment in hedge funds. Nevertheless, as stated before, there is a noticeable growth, particularly in funds-of-hedge-funds.

An approach to the investor protection issues

A number of observations can be made regarding the investor protection regulatory implications of allowing hedge funds to be sold into the retail market:

1. As mentioned above, it is not really possible to define hedge funds. This means that it will be extremely difficult to arrive at a legally sound description for the purposes of laws and statutes.[7]
2. The primary concern for CIS regulators is that investors can adequately assess the proposition, including whether an investment in a hedge fund is suitable for their investment needs. The hedge fund must disclose adequate information about its strategy (including the risks involved) and the terms and conditions involved in investing in the fund. In addition, the investors' interests need to be reasonably protected, for instance by risk diversification requirements.
3. Whether investment vehicles may, or may not, have a useful role in the capital markets, is up to the markets to decide.
4. The major issues with regard to hedge funds seem to be two-fold. In the first place there is the issue of systemic risks and exposure to hedge funds by banks and investment firms: this is outside the scope of this paper and has been adequately addressed by other fora. In the second place, there is the notion that hedge funds are inherently risky, and should therefore not be open to non-qualified retail investors. Given the diversity in the kinds of hedge funds, it would probably be unwise generally to conclude that hedge funds as a group are riskier than certain ‘normal’ funds that are specialized (e.g., funds investing in the IT-sector or in private equity). Indeed, the use of hedging techniques may in fact produce a more predictable return.
5. Most regulators are more concerned with funds-of-hedge-funds than hedge funds themselves as the former are the primary vehicles for attracting retail investment in this sector.

[7] The term "hedge fund" is often used as a reference to a particular investment strategy (or strategies). That strategy can be carried on in as many different structures as there are structures – it can be done in closed ended funds (companies), open ended funds, trusts or even through fund links in life insurance policies. So the ‘structure’ does not necessarily form any part of their definition.

It is for individual national governments and regulators to determine whether or not hedge funds are suitable for sale to the retail market. However, where a jurisdiction does permit hedge funds (or funds-of-hedge-funds) to be marketed to the retail public, there are a number of issues that the regulator may wish to consider, which are described in more detail below.

In the light of the observations made above, it is useful to explore whether the principles embodied in the regulation of CIS are relevant for the regulation of hedge funds (including funds-of-hedge-funds). It is argued here that this is the case and that, if jurisdictions are willing to permit retail investment in (funds-of-) hedge funds, it is not necessary, from a viewpoint of investor protection, to develop new approaches that significantly divert from those principles in order to accommodate hedge funds. The main objective of CIS-regulation, after all, is not to prevent the incurring of losses on investments, but to create a framework within which products are offered that are suitable for retail investors. This can be achieved by, among other things, ensuring that the risks involved are disclosed in such a fashion that they are understandable for retail investors.

The 1995 IOSCO *Principles for the Regulation of Collective Investment Schemes* provide a sufficient framework for the regulation of (funds-of-) hedge funds. Two of those principles may, however, not fit especially well. The first is principle 7 on Asset Valuation and Pricing, especially the statement that a CIS must redeem its units at the request of any investor, given the situation that hedge funds often do not have a pure open end status. The second is principle 8 on investment and borrowing limitations, which are directed at traditional funds. Even though a broad interpretation of this principle could be applied for hedge funds, such funds may use unusual or innovative leverage or limited investment strategies, which may conflict with this principle. Therefore, subject to additional disclosure being provided, in order to carry out their investment objective hedge funds may need to be exempted from regulation that is more appropriate to traditional CIS, particularly regulation of investment restrictions and practices.

Another IOSCO document prepared by IOSCO's Working Party 5 (the predecessor of SC5), *Disclosure of Risk, a discussion paper*, September 1996, is also relevant. Certainly in 1996 the document was drafted with a 'mindset' for traditional funds. It is, nevertheless, also applicable to hedge funds. See especially paras 2.2 and 2.4 of this document. Para 2.2 states: "In order to make an informed decision, an investor who is contemplating investment in a CIS needs to understand both the potential rewards and the associated risks." Para 2.4 states: "Risk disclosure by a CIS should assist investors in understanding the relationship between risk and return, so that investors evaluating CIS performance do not focus solely on return, but also on the risk assumed to produce the return. Risk disclosure should help investors assess whether a CIS's potential return is an adequate reward for the risks taken."

A number of disclosure issues can be identified that are either unique to hedge funds or magnified in the case of hedge funds:

- **Fund Strategy and Disclosure of Risks –** Hedge funds employ a diverse range of strategies, many of which are unfamiliar to retail investors. It is therefore important that the strategy of the fund is explained in a way that is comprehensible to retail investors and that the risks inherent in the strategy are clearly stated. Unwillingness to provide full disclosure seems to be a characteristic of many hedge funds, the reason often given that such disclosure would enable competitors to gain insight into their 'unique' strategy.[8] It can be questioned whether this is a valid argument. In disclosure documents of normal CISs, a description of the investment policy, aims and risks will be given, but that is not to say that the manager will give insight into why particular choices will be made to buy or sell certain stocks. This follows from the fiduciary relationship between the investor and the manager: the investor mandates the manager to make decisions within certain (often broad) parameters.

- **Target Performance/Prospective Financial Information –** It is much harder for investors to judge whether a hedge fund is performing well or not than for traditional funds (where ready comparisons can usually be made against widely available indices). Therefore, in order for investors to gauge the performance of the fund it is necessary for them to have more of an indication of the performance that the hedge fund manager is targeting (whether this be an absolute level of performance or relative to a given benchmark).

- **Fees and Charges –** Hedge funds generally charge a performance fee as well as a management fee. In order that this is readily comprehensible to investors, the basis of this fee needs to be set out clearly.

- **Past Performance –** Given the emphasis in hedge fund strategies on the skills of the manager rather than general market movements, it is particularly important that timely information on performance of the fund is available as it is less likely that returns will be correlated with general market movements.

- **Lock up Periods/Liquidity –** Many hedge funds place restrictions on when investors can withdraw their money and/or have a notice period in advance of payment of withdrawal. These should be stated clearly so that investors are aware that they will not have instant access to their money. All funds-of-funds and single strategy hedge funds which invest in illiquid assets should also disclose this clearly to investors.

- **Valuation –** Some hedge fund strategies involve investing in illiquid, hard to value securities. Where the fund invests in illiquid securities, it is important that the basis for valuing the portfolio is clearly made and that the risks of investing in illiquid underlying investments are properly explained.

- **Related parties/outsourcing/service providers –** Hedge funds commonly outsource part of their operations to related parties. It is important that this, and any related consequences for fees, is fully disclosed. Where significant reliance is being placed on service providers such as prime brokers to perform services such as valuation and reconciliation, this should be disclosed. It is important that the custodians and accountants to the fund have appropriate expertise in the strategies that it follows.

- **Issues specific to Funds-of-Funds:**

- *Information on underlying funds and how they are selected* – If investors are to have any idea about the risk profile of a fund-of-funds, they will need information about the nature

[8] Opaqueness on the part of hedge funds transfers, of course, upwards into the quality of the information that is provided by the funds-of-hedge-funds that invest in them.

and risks of the underlying funds (as well as the criteria used by the fund-of-funds manager in selecting the underlying funds).

- *Due diligence on underlying funds* – One of the critical functions performed by the manager of a fund-of-funds is the performance of due diligence on underlying funds. However, the investor generally has no recourse in the event of a problem with the underlying fund. It is therefore important that the investor receives a clear explanation of the due diligence process and liability of the manager if anything goes wrong with the underlying funds.
- *Diversification* – The number of underlying funds the fund-of-funds invests in and the concentration in individual underlying funds is an important component of the risk of the fund-of-funds. Ideally, the fund should disclose the maximum percentage of its capital that it will invest in any one fund and the minimum number of funds that it will hold. This could be usefully supplemented by recent data showing the composition of the fund at a given point in time.
- *'Double' Fees* – It is customary for management and performance fees to be payable both at the fund-of-fund level and from the fund-of-funds to the underlying funds. Investors should be made aware that investing through a fund-of-funds structure means that, in effect, two sets of fees are payable on the investment. This could be helpfully illustrated by an example showing the total amount of fees payable from the investors' money.
- *Investment activity at fund-of-funds level* – Normally, funds-of-funds invest on a long-only basis in underlying funds without taking positions themselves. If the fund-of-funds plans to "overlay" the investments in underlying funds by making investments itself, this should be clearly disclosed to investors.

The foregoing means that a regulator applying the traditional approach via-à-vis hedge funds has two basic choices:

- authorization of a hedge fund if the regulator is, among other things, satisfied that the investment policies and risks are adequately disclosed in the prospectus (and is therefore willing if necessary to exempt the hedge fund from traditional CIS regulation that would restrict how the hedge fund meets its investment objectives or strategies) and that the fund is otherwise suitable for retail investors, or
- non-authorization of the fund or restricting the offering of the fund to professional or qualified investors if the manager is unwilling to provide the level of disclosure required for retail investor participation.

This approach would also seem to be applicable to funds-of-hedge-funds. With indirect investment by a CIS in offshore or unauthorized CISs, regulators may be concerned that the investors will indirectly hold investments that would otherwise not be permitted in the regulator's own jurisdiction. The methods regulators employ to address these concerns (varying from additional disclosure requirements to prohibitions on master/feeders) can also be applied when a CIS invests in offshore or unauthorized hedge funds. For the regulation of funds-of-hedge-funds it is furthermore of utmost importance that the manager applies, and is tested on, a sufficient degree of due diligence when selecting hedge funds into which the manager may wish to invest. This includes the necessity of being sure that the hedge fund is valued correctly and in a timely fashion. Without a stringent due diligence process by the manager of the fund-of-hedge-fund, the interests of the investors could be affected adversely.

Depending on the legal framework for the regulation of CISs in the jurisdiction, the potential responses of the regulator include:

- prohibiting direct or indirect retail investment, as the view is taken that the underlying product is too risky or complex or otherwise unsuitable for retail investors:
- allowing limited indirect investment through a professional fund manager;
- imposing additional competency and experience requirements on the manager;
- additional attention to the due diligence applied by the manager of funds-of-hedge-funds when selecting hedge funds;
- permitting direct investment but limiting it to more sophisticated investors, by imposing a minimum subscription level;
- requiring additional disclosure about the risks associated with the investment and the strategies followed by the fund;
- requiring investors to sign an acknowledgment of the risk/complexity warning;
- placing greater emphasis on the proficiency of sellers of the hedge fund to understand the product before recommending it to their clients;
- placing greater emphasis on the manager's internal control processes, including valuation procedures.

Of course, the regulator will be challenged by the supervision of hedge funds as they often employ styles, techniques and technology that are ‘state-of-the-art.’ This means that it may be difficult for a regulator to judge whether or not the investment policy and risks are adequately disclosed and to judge, during on-site inspections, whether the manager is operating in conformity with its stated policies. The regulator must have sufficient comfort in this respect. That could be achieved through staff training and/or through the use of specific statements of independent parties (such as the external auditor). Finally, it is believed that the March 2002 IOSCO Technical Committee report on *Investment Management: Areas of regulatory concern and risk assessment methods* provides a framework that can easily be applied when assessing the regulatory risks of retail investment in hedge funds.

Summary and recommendations

In this paper a number of approaches have been identified that can be used by regulators when they choose to allow forms of retail investment in (funds of) hedge funds. Systemic risks of exposures to hedge funds by banks and investment firms, which have been considered at length by both the IOSCO Technical Committee and the Financial Stability Forum in recent years, are outside of the remit of this paper and have not been considered.

Definition

Before being able to set rules, it is necessary to determine the types of CISs involved by making clear what hedge funds are. It is however very difficult to arrive at an adequate definition of hedge funds. It is easier to find a broad consensus with a negative description and the use of some identifying characteristics and investment strategies, which are detailed above.

An approach to investor protection regulatory issues

The possibilities for retail investment in hedge funds have significantly grown over the past years. Some jurisdictions allow forms of direct retail investment and many jurisdictions allow indirect retail investment.

Where a jurisdiction does permit the marketing and selling of hedge funds to retail investors, the key regulatory concerns that arise are:

1. That the retail investor may not adequately understand the risks involved in or the complexity of the product; and
2. That the manager may not have the competence or the processes and controls required to adequately manage the fund and explain this clearly to his investors.

These two concerns lead to the following guidelines:

- Disclosure: The investor should be able to know what the risks of the fund are

Investors in hedge funds often face a complex combination of risks: market risk, operational risk, credit and counterparty risk etc. In order to understand those risks hedge funds have to disclose their strategies in detail. That means that a complete list should be given with the strategies a fund follows and a description per strategy of the risks involved and the handling of those risks by the fund. It is however not necessary for the funds to reveal their current individual investments, for that would make their market position rather difficult. However hedge funds marketed and sold directly to retail investors should be subject to the same disclosure requirements as other CIS (with annual and semi-annual disclosure of holdings being the minimum requirements). In addition, this paper identifies a number of areas which present particular disclosure issues in relation to hedge funds. IOSCO members may wish to consider whether their disclosure requirements are adequate in these areas.

- Competent management

The management and internal control process of hedge funds may require additional attention of the regulator. The complexity of the risks, the investment strategies, the management of the administrative organization and the valuation of the assets can demand special skills. The regulator should consider the adequacy of those skills, while accepting that it is impossible to second-guess the commercial judgments being made by the manager and for which the manager is responsible.

This is also important for funds-of-hedge-funds. The manager should be able to make a considered choice between the many funds he could invest the fund's money in. That means that he must at least understand the strategies of the funds and that he should apply adequate due diligence. But he also should be able to explain to his investors how the fund selection takes place, what the procedures for monitoring the funds are, what criteria are used for switching the investments between funds and how the valuation takes place. In addition, managers of hedge funds should be held to the same general standards in managing their hedge funds as they would be in managing any other publicly offered CIS.

Regulation of hedge funds poses challenges for regulators. Regulators should not seek to lead or anticipate the market. The primary responsibility for managing and controlling the risks lies with the CIS operator. The regulator's responsibility is to set, oversee and enforce appropriate regulatory requirements, in the interests of protecting the investor.

Concluding remarks

Further research work on such investor protection issues as identification of hedge funds, their authorization and methods of valuation may be useful. However, it should be noted that the members of SC 5 do not consider retail investment in (funds-of-) hedge funds to be high. Even though such funds manage to attract considerable attention from regulators and the financial press, the amount of retail investment involved is still quite modest in a relative sense. Furthermore, existing regulatory and supervisory structures applicable to CISs generally have proven to be sufficiently flexible to address investor protection issues raised by (funds-of-) hedge funds.

This is not to say that hedge funds do not give rise to a number of other regulatory issues that are important, such as:

- short selling;
- fee structures;
- whether the use of derivatives by hedge funds could lead to a more relaxed regulation of use of derivatives by traditional funds;
- the use of benchmarks as a source of information for investors to compare the results of the CISs they invest in; and
- the methods of distribution and the quality of the advisors.

These issues are, however, not limited to hedge funds as a phenomenon, and may warrant broader consideration than just in the hedge funds context.