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Hedge Funds – New Regulatory Challenges

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AN INTERNATIONAL PERSPECTIVE

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Thank you, Mr. Chairman.

It is an honor to speak before this distinguished international assemblage of regulators and private practitioners at the invitation of the Securities and Exchange Board of India (SEBI) on the occasion of the 32nd Annual Conference of IOSCO.

It is fitting that this panel take place in "Incredible India," a market phenomenon of the 21st Century. It is fitting that this Conference be held in Mumbai—a financial capital where innovative market and technology giants provide examples to both emerging and mature markets and a home to some of the largest markets in the world. It is also fitting that we convene in a place situated on the trade routes of history and imbued with the romance of international commerce.

India is not only an emerging financial power-house, it is also a bazaar of cultural delights. India 's unique literature inspired development of Arabian, Persian and European literature, including La Fontaine's fables and The Thousand and One Nights. Indian folk, religious, and romantic tales, poetry, sculpture, miniatures, and architecture have inspired musicians, writers, and philosophers around the globe—and from the Beatles to Emerson. The Indian institution of democracy is as old as the ancient village republics, though its modern constitution dates from the middle of the last Century. And, although Indians speak multiple Indo-European languages, India's unifying language is the *lingua franca* of finance, that is, English. So it is fitting to speak of innovation, investment diversity and open markets in this increasingly receptive environment.

Managed Funds Association intends to comment officially on the matters submitted for public comment by the Technical Committee and before this panel today. However, in the meantime, I would like to share with you some thoughts of my own.

My remarks will address:

- First: The evolving international consultative *process* on financial markets issues,

- Second: How the *substance* of IOSCO's deliberations relate to ongoing improvement of industry practices, and

- Third: An update on the regulatory state of play.

Background and Perspective: Before beginning, let me set the scene so that you can better understand my perspective. MFA (Managed Funds Association), founded in 1991, is the only US-based global membership organization dedicated to enhancing understanding of the hedge fund industry, fostering dialogue with regulatory authorities and otherwise improving communications about the alternative investment sector of the capital markets, including hedge funds, fund-of-funds, and managed futures funds.

MFA's membership of over 1,300 professionals manages a substantial portion of the more than 1.4 trillion US$ dedicated to alternative investments. Our members include representatives of a majority of the 100 largest hedge funds groups in the world. These managers collectively manage in excess of 530 billion US$ in assets and pursue a wide range of investment strategies. Many are investment advisors registered with the US Securities and Exchange Commission. Our representation takes account of this membership configuration.

While MFA estimates total industry size as comprised of 13,000 single funds with about one-third as many managers, less than 2% of these manage more than 80% of all hedge fund assets. There are, however, multiple emerging hedge funds, many of them with assets under 50 million US$ each. According to data from the McKinsey Global Institute, recently quoted in *Foreign Affairs*, hedge fund assets have quintupled in the past eight years, while the world's stock of other assets, including bank deposits has only doubled. Some believe hedge funds account for a third of the turnover in US equities and are counterparties to most of the more exotic financial instrument transactions.

Alternative investments—as you are aware—are most often described in the regulatory literature

- *By what they are not*: Retail investments subject to public offering rules

  Rather than

- *By what they are*: Sophisticated investment products that use varying strategies and rely on arbitrage, long/short hedging or contrarian or innovative investment approaches that can help further diversify the capital markets, inject liquidity irrespective of market direction, and provide added price information that translates into improved price efficiencies.

It is this contribution of alternative investments to the efficiency of the market system, and the interconnection between "investment freedom," "investor protection," and disclosure that I would like to emphasize today.

So let me turn now to recent IOSCO initiatives.

Process.

Because alternative investments largely operate outside the contours of regulation intended for publicly offered retail investments, in every *jurisdiction hedge funds are the quintessential global product.* Thus, it is not at all surprising that they are a subject of international interest.

Indeed, regulatory reaction in differing jurisdictions variously ranges between

- Movement to adopt structural modifications to more freely admit such funds access to their investor base or markets and

- Criticism of hedge funds purportedly disruptive features, such as: their strength as buy side competitors for market share and their activist or responsive shareholder activities

depending on domestic sentiment and national points of view. This range of impressions of vehicles for such significant money flows supports the types of far flung dialogues that profitably can be hosted within the IOSCO community.

This panel, for example, is speaking in the context of the March 27 pre-Annual Meeting release for public comment by the Technical Committee of a Consultation Report, entitled: "*Principles for the Valuation of Hedge Fund Portfolios*" with a comment return date of 21 June 2007.

What is admirable about this paper is the process that went into it. That process—which I applaud—was one in which this international community of regulators decided to measure theory against practice by including industry participation at the outset of its search for an appropriate approach rather than at the conclusion of a fully-negotiated consensus-driven product. Rejecting the ivory tower view of regulators acting in isolation, the working party sought a spectrum of market-based views at the point of lifting the draftsman's pen before regulatory opinions solidified or policy positions were irrevocably and immutably taken. As Mr. Waters said in his presentation, the industry drafting group included hedge funds, prime brokers, auditors, accountants, valuation agents and fund of fund managers, who perhaps for the first time had an actual hand in an IOSCO drafting exercise.

I understand that the Chairman of the Technical Committee, Michel Prada, believes that more input from the private sector, and broader input than that which is currently comprised within the SRO Committee, might be useful in setting IOSCO priorities and in developing regulation that takes timely account of market developments. I encourage IOSCO to consider various strategies for seeking practitioner input on matters of relevance to multiple regulators internationally. I believe consultation typically enhances regulatory work product and that such consultation could help assure IOSCO of broader awareness and acceptance among the financial community.

Even in my own jurisdiction, where public commentary is commonplace, the failure to expose operational issues early enough in any regulatory process can impede development of effective solutions, result in too prescriptive or too parochial approaches or frustrate needlessly desirable market change. So I commend the direction in which IOSCO seems to be moving on public consultation.

One other point on process: We at MFA believe that the practice of "standard setting" or "guidance provision" at the international level should focus on overarching, high-level principles that seek to document common or consensus positions and to eliminate inconsistent duplications. Such work should not:

- specify structures,
- determine the merit of particular investments, or
- unduly constrain strategies or business processes.

Our ability to engage in dialogue, and even common work programs, should help to promote more open approaches to international market players and better understanding across cultures and borders of common concerns about rules of the game, the players and how the game is played.

Substance:

Turning now to substance:

We certainly concur that risk management and appropriate controls are critical to hedge fund operators and operations.

We also concur with the recent pronouncements of the President's Working Group for Financial Markets in the US (PWG), that is, the *Principles and Guidelines Regarding Private Pools of Capital* (Principles and Guidelines). These Principles and Guidelines identify investor protection and systemic stability as principal concerns. The PWG seeks to encourage private pools of capital to produce sufficient information for:

- fiduciaries and sophisticated investors to perform effective due diligence in evaluating and making their investment decisions and

- counterparties, lenders, prime brokers and other intermediaries to review their investment policies and risk tolerance levels and to address lack of information by reducing exposures, increasing collateral and effective stress testing.

The PWG states that private pools of capital can be appropriate investments for informed, sophisticated (not retail) investors and encourages sufficient disclosure and the establishment of policies and procedures that make the dynamics of market discipline work properly.

In addressing concerns that less sophisticated investors could be exposed to hedge funds through their participation as beneficiaries of pension funds (for example), the PWG stated that such concerns “can best be addressed through sound practices on the part of the fiduciaries that manage such vehicles” and “who have a duty under applicable law to act in the best interest of the beneficiaries.” The PWG specifically recommended:

- evaluating the fund’s manager,

- conducting appropriate due diligence regarding the funds valuation methodology and risk profiles, and

- considering whether the suitability and size of an investment are consistent with investment objectives and the principle of portfolio diversification.

The PWG also recommends that hedge fund managers and their lenders and counterparties take account of industry best practices. MFA has been a prime mover in the development, evolution, and dissemination of best practices. The MFA ‘s “*Sound Practices for Hedge Fund Managers*” was first adopted in 2000 in response to a 1999 recommendation by the PWG that hedge funds establish a set of sound practices for their risk management and internal controls. MFA updated and expanded these practices in 2003, and again in 2005, as a response to industry developments. The 2005 version was widely distributed to policymakers in Washington and to US and international regulators. The practices set forth a detailed framework for internal policies, procedures and controls. For example, they address:

- internal trading controls,
- responsibilities to investors,
- valuation,
- risk management,
- liquidity planning,
- regulatory compliance,
- transactional practices,
- business continuity and disaster recovery,
- codes of professional ethics, and
- best execution, soft dollar practices and other matters.

Similarly to the IOSCO report, the MFA regime addresses valuation and requires disclosure of the valuation methodology, the use of fair value reporting, high standards of accounting, and consistent, verifiable procedures, including for illiquid investments.

We believe that the nine core principles outlined in the IOSCO paper are, by and large, consistent with MFA's recommended valuation policies and procedures. Our 2005 document provides eight core recommendations:

(1) That the hedge fund managers policies and procedures incorporate the concept of fair value.
(2) That the policies and procedures be fair, consistent and verifiable.
(3) That pricing policies and procedures assure that NAV is marked at fair value.

a. While we emphasize independence in valuing portfolios, in this section we state that in valuing certain instruments where market prices do not exist or are not indicative of fair value, it may in some instances be appropriate to seek the input of the portfolio management team and utilize their expertise.

(4) That hedge fund managers choose reliable and recognized pricing sources.

a. This section goes into some detail about considerations in valuing over-the-counter options, complex derivatives, mortgage-backed securities and similar instruments.

(5) That managers establish policies for determining valuations associated with instruments that may have multiple “official” settlement prices.

(6) That a hedge fund manager should evaluate the use of alternative methods for valuing illiquid, or otherwise hard-to-value, securities or other investment instruments.

a. This section is critical as it highlights that there are varying methodologies for valuing “side pockets”, an area getting more and more attention as there is more convergence between the activities of private equity funds and hedge funds.

(7) That managers establish practices for verifying the accuracy of prices obtained from data vendors, dealers or other sources.

(8) That managers establish policies for determining the frequency of a hedge fund’s NAV.

At the outset, we believe that the IOSCO draft principles are largely consistent with MFA’s sound practices in this area. MFA currently is in the process of substantially updating the practices for 2007 and also expects to help promote investor financial literacy through the development of due diligence materials.

While I concur in the need for documentation of policies and procedures for valuation, and that such policies be consistently applied, verifiable, and properly disclosed to investment participants, particular governance processes for valuation should not be prescribed. Our institutional view is that "one size does not fit all" in the hedge fund industry. There are such substantial differences among types of funds, the expected sophistication of fund participants, typical fund structures, and distribution methodologies among different jurisdictions; even cautious governance recommendations may be inappropriate.

MFA has testified that it supports the move by the US Securities and Exchange Commission to limit access to private placement of hedge fund interest to individuals of sophistication and high net worth. MFA does not favor the retailization of hedge funds and indeed believes that such retailization, if burdened with investor protections for non-sophisticated investors, could adversely affect the ability of hedge funds to execute multiple trading strategies and to serve as shock absorbers, diversifiers and efficiency providers in the general economy.

Our US approach is to balance investor protection and investment freedom. The balance struck limits the investor base of those funds able to exercise total investment freedom, subject to anti-fraud and manipulation provisions, of course. Access to funds with the unlimited capacity to develop trading strategies is limited to those investors who can understand fully the types of trade offs and risks that they are undertaking and have the financial wherewithal to withstand them. MFA sees no need to move the fulcrum closer to making these types of investments available to retail investors or to alter regulation to anticipate that eventuality. This is true even though some commenters on the SEC proposal are clamoring for access to hedge funds-type returns. We believe that the balance being set within the US has fostered investor protection, advanced market discipline against systemic risk, and been consistent with the policies of disclosure as opposed to merit-based regulation. We believe that now is not the time to upset this balance.

That US sage and global celebrity, Alan Greenspan, more than once pointed out that hedge funds can act as shock absorbers, adding depth and liquidity to the financial markets. In testifying before Congress, he offered the opinion that such funds have “proved essential to our ability to absorb so many economic shocks in recent years.” More recently, The President’s Working Group stated that “hedge funds and other investors with high tolerance for risk play an important supporting role in the financial system in which various risks have been distributed across a broad spectrum of tradable financial instruments.” In particular, they noted “with financial intermediation increasingly taking place in the capital markets instead of banking markets, prices play a larger role in the allocation of capital and risk.” In effect, then, active management, multiple strategies, and sophisticated investors are a good thing—assuring efficient pricing mechanisms and appropriate market discipline. Mutual funds measured against how well they track indices that reflect market consensus use more passive or directional strategies than hedge funds. Alternative investments must produce absolute returns and thus can be the source of contrarian demand when the markets overshoot in either direction.

We thank IOSCO for its interest in our views and this audience for listening to our advocacy of regulatory restraint in this remarkable forum. I look forward to a lively debate and provocative questions on these important issues.