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?

Davide Erro

Chief Investment Officer
Gandhara Advisors Asia Limited, Hong Kong
IOSCO ANNUAL CONFERENCE
PANEL 2: HEDGE FUNDS - HOW FAR IS IT NECESSARY TO REGULATE?

PANELLIST - DAVIDE ERRO
Topics

2. Hedge Fund Growth in Perspective
3. Metrics for Hedge Fund Development
4. Regulatory Issues - Macro
5. Regulatory Issues - Micro
6. Making Hedge Fund Investing Similar to Investing in Companies
7. Appropriate Riskiness of Hedge Funds
9. Gandhara Best Practices
10. Development of Human Capital in Hong Kong
11. Forward Looking Hedge Fund Investing
12. Conclusion
Hedge Fund Growth In Perspective

- Small base in Asia

- Define type of hedge fund you want by characteristics
  - Size
  - Stability
  - Facilitating allocation of capital

- Industry growth is positive sum game
Metrics for Hedge Fund Development

- Merger arbitrage spreads
- Changes in corporate structures to release value

Continued growth of hedge funds is beneficial to Asia and Hong Kong
Regulatory Issues - Macro

- **Systemic issues**
  - Credit
  - Financial system
  - Liquidity
  - “LTCM” issues

- **Barriers to entry**
  - Economics of scale
  - Institutionalization of industry

- **Reputation**
  - Protect good players from contamination of bad players
  - Regulators role to differentiate between actors

---

*Important but, from my perspective, adequately dealt with by Regulators and Prime Brokers*
Regulatory Issues - Micro

- Need to facilitate decision-making for investors into funds

- Within context of risky investments, need good infrastructure to make decisions
  - Clarity of pricing and costs of the fund
  - Alignment of interests between GP and LP
Making Hedge Fund Investing Similar to Investing in Companies

- Transparency of ownership and changes in ownership
- Insider investment/transactions
- Compensation and form of compensation (stock vs cash)
- Conflicts of interest (personal dealing, multiple promote fees)
- Relationships with brokers
Appropriate Riskiness of Hedge Funds

- Great focus on low risk but taking smart risks is important
  - Problem of asset gatherers
  - Need to allocate capital
  - Higher compensation moving from call to equity to debt
  - Need to find the right balance
  - Returns on motivation and psychology of hedge fund managers

- Risk is part of investment process (and mandate) but should not be compounded by operational risks and distractions
  - Consistent theme of under-investment and being penny wise and pound poor on building infrastructure
    - Number of middle office staff
    - size of office
    - experience of COO
    - quality and number of assistants
Very hard to choose a good investor
but can more easily choose a structure
that should make good risk adjusted returns likely
Gandhara Best Practices

- 50% of principals’ net wealth invested in Fund and substantially all financial assets
- 75% of bonuses reinvested
- No “soft dollars”
- Independent Board with substance
Development of Human Capital in Hong Kong

• Historical hedge fund investing
  - Small cap
  - Flow of funds
  - Events
  - Distressed investing

• Valuation was not a focus

Characteristics market can provide to attract people ...

• Liquidity especially in big caps
• Fewer controlled companies to ensure economic motivation
Forward Looking Hedge Fund Investing

- How much is an asset worth?

- What should this company earn?
  - Develop valuable dynamic with management
  - Facilitate allocation of capital
  - Promotes market depth

What Will This Look Like?

- Lower index volatilities
- Lower correlation between stocks/high single stock volatilities (compared to index)
- Wider band of multiples
Conclusion

- Hong Kong is a great regulatory environment because it commands respect as a well-regulated financial center

- Greater transparency surrounding needs/requirements of investors in ensuring alignment w/GP

- Roadmap for development of Hong Kong as a center for human capital