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

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Outline of Remarks
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Hedge Funds: How far is it necessary to regulate?
Introduction

- **My personal views**

- **Focus:** Regulation should be tailored to an intelligible purpose.
  - What’s the problem we’re trying to solve?

- **Distinguish:** the general deregulation of financial industry.
  - Decline of functional and geographic barriers.
  - Increasing number of agents and the amount of capital that arbitrages the entire capital structure.
  - Hedge funds are just one example.

- **Distinguish:** the endemic problem of liquidity illusions.
  - Underlying issue with LTCM; again, not limited to hedge funds.
  - Especially with new instruments (short volatility histories).
  - Less capital/less sustainable vs. multiplicity of agents/more resilience.

- **Distinguish:** the “European” issue.
  - Is it desirable to have a market in corporate control?
Licensing

- Fit & proper licensing is appropriate and desirable.
  - But note: creates barriers to entry.

- Purpose: prevent fraud, bad actors.

- If take on licensing regime, regulators carry a heavy burden:
  - Must actually do it: determine who is fit and proper.
  - And whether they remain so.
Independent Audit & Valuation

- If a licensing regime: does the regulator validate:
  - The independence of audit?
  - The accuracy of books & records?

- “Aggressive” marks:
  - Should auditors give more specific attestation of valuation?
  - Not mere “reasonableness”?
What transparency of risk taking?

- Disclosure of risk-taking tactics, position reporting, a poor idea.
  - Purpose to “control risks” unlikely to be fulfilled; impractical.
  - Same transparency for others? Banks? Insurance companies?
  - Drives business to un-licensed entities.

- Summary risk data: e.g., VaR, tracking error.
  - Disclosure to creditors/prime brokers & investors.
  - Regulators? Public? For what purpose?
    - Too much leverage? Too much risk?
    - A safety net for hedge fund investors?

- What differences do we want in investment vehicles?
What form of regulation is most effective?

- Public regulation or private?
- Problem of “prime brokers” who don’t see whole picture.
- Fund of funds industry a form of private regulation?
- What’s the best mix?