A global approach to regulating hedge funds?

An extract from AM News June 2009

PRICEWATERHOUSECOOPERS

A global approach to regulating hedge funds?

The International Organisation of Securities Commissions ("IOSCO") advocates a sensible way of regulating hedge funds, which strikes a good balance between 'micro-prudential' and 'macro-prudential' considerations, so minimising the risk they pose to the financial system.

Wendy Reed
PricewaterhouseCoopers (Belgium)
+32 2 710 7245
wendy.reed@pwc.be

David Sapin
PricewaterhouseCoopers (US)
+1 703 918 1391
david.sapin@us.pwc.com

Adams Chan
PricewaterhouseCoopers (Hong Kong)
+852 2289 2784
adams.wf.chan@hk.pwc.com

In response to the financial crisis in its November 2008 statement, the G20 advocated appropriate regulation and oversight for systemically important institutions, mentioning hedge funds specifically. At the same time, it stressed the need to ensure that "all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances".

This rather broad-reaching statement was not repeated following the April 2009 summit but the focus on systemically important institutions, including hedge funds, remained. In effect, the Declaration on Strengthening the Financial System, which was annexed to April summit's statement, stated: "Hedge funds or their managers will be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators, including on their leverage, necessary for assessment of systemic risks that they pose individually or collectively. Where appropriate, registration should be subject to a minimum size. They will be subject to oversight to ensure that they have adequate risk management. We ask the Financial Stability Board (FSB) to develop mechanisms for cooperation and information sharing between relevant authorities in order to ensure that effective oversight is maintained where a fund is located in a different jurisdiction from the manager." This was further supported by the G20's position on tax havens and non-cooperative offshore jurisdictions.

Some question whether hedge funds or their managers are systemically important. Industry claims that it was not a major cause of this crisis are well-founded. Nevertheless, there is growing recognition that actions the hedge fund industry was forced to take as the crisis unravelled did exacerbate the markets' problems, thus having a systemic impact. Although the industry itself is not systemically important in size (the hedge fund industry is estimated at just $1.4 trillion of assets under management), leading industry players do recognise that the crisis has showed them to be 'systemically important institutions'[2] and that, as a result, they should be subject to appropriate oversight in the future.

G20 requirements

The G20 demands essentially three things: i) hedge fund or hedge fund manager registration, ii) adequate risk management systems and iii) appropriate levels of transparency vis-à-vis markets and regulators. These should be underpinned by consistent, enforceable industry standards. A consultation report issued by IOSCO in March 2009[3] goes a long way to addressing all these issues. Importantly, it stresses that "it is very important to emphasise that any regulatory measures or standards need strong collective global action and application – as the hedge fund industry is highly global and mobile".[4]

Looking at these various points, industry bodies have made progress at the global level towards identifying best practice standards. A group of key hedge fund associations, representing firms on both sides of the Atlantic, have set up the hedge fund matrix comparing existing industry codes.[5] According to Reuters, on 12 March, three associations (PWG, MFA and AIMA) wrote to the Financial Stability Forum confirming their commitment to converge on a unique set of best practices as required by the G20. There is still some way to go in this regard, however, as the comparative tables in the hedge fund matrix clearly show and, as IOSCO points out, although the existing codes may be quite comprehensive, "two main issues should be highlighted, the lack of regulatory status and of consistent implementation".

In terms of registration, the requirement for fund manager registration or authorisation exists in many countries now.[6] The notable exception at this stage is the US; however, a recently proposed bill would require hedge fund managers to register with the Securities and Exchange Commission (SEC).
It seems unlikely that, in the current circumstances, this will struggle in the same way as earlier SEC moves in this direction. Nevertheless, it is worth noting that in spite of IOSCO's talking about these two in the same breath, registration and authorisation are necessarily not the same. If they provoke similar levels of oversight, however, this difference should be inconsequential.

Removing conflicts of interest

Conflicts of interest exist currently in the way the industry is structured in some jurisdictions. IOSCO noted that "many managers both manage hedge funds and raise capital for them and in certain cases, administer, value and safeguard the assets". Naturally, as part of the thinking around an adequate risk management framework, there is growing focus on effective segregation of different facets of the hedge fund value chain in order to remove the risk of conflicts of interest. EU requirements have long supported independent depositaries and custodians (and segregation of client assets), and existing national requirements for hedge funds – and indeed Asian and European practice and the geographic split of the industry – support independent administration and independent valuation verification to some extent, although these requirements could and, most likely, will be strengthened. U.S. based funds have not been subject to the same types of requirements regarding independent custodians and administration, but are seeing increasing demand from their investors regarding the use of independent, third-party administrators. The SEC is also considering rules requiring annual "surprise" audits of advisers which maintain custody of client assets. There is definitely a move in the US towards the EU approach to independent custody and administration.

In Asia, while the "segregation requirements" are mandatory for hedge funds which are offered to retail investors (and which are subject to regulators' supervisory/authorisation requirements), given the participation of the Asian regulators in IOSCO and the fact that many hedge funds (both public or private) in the region are domiciled in other jurisdictions (e.g. EU), it is envisaged that the aforementioned move taken by the regulators in Europe and US may impact the existing approach adopted by their Asian counterparts in different ways. Consequently, the compliance standards on hedge funds (and hedge fund managers) will probably be increased.

Traditionally, the risk posed by hedge fund managers as counterparties to financial transactions was controlled largely through their relationship with one prime broker. More recent moves by hedge fund managers towards multiple prime broker relationships, perhaps with a view to managing their own counterparty risk, has reduced the validity of the former as an effective risk buffer against the financial markets generally. The crisis has also underlined that hedge fund managers need to manage a wider range of risks more effectively, including market, credit, operational and, importantly, liquidity risks. As a consequence, IOSCO has recommended the establishment of comprehensive and independent risk management and compliance functions, concepts which are closely aligned to common practice in other financial sectors (banking, securities and insurance) in the EU but which, nevertheless, could still prove challenging for some fund managers. From the (small) fund manager perspective, the principle of proportionality (the requirements should be consistent with the nature, scale and complexity of the organisation) must be applied.

Improving transparency

The third G20 requirement relates to enhanced transparency, both towards the markets and regulators. IOSCO notes that the informational asymmetries which exist between hedge fund managers and their clients may belie the industry's contention that sophisticated and professional investors are capable of making informed decisions. The consultation report also notes that while there are good commercial reasons for funds and their managers to provide information to investors, direct creditors and counterparties, "some aspects of investor information may not be as transparent as it could be". IOSCO, therefore, advocates enhanced disclosures to investors in terms of the actual investment products as well as business models, investment strategies and risk management processes of the funds.

The one area IOSCO does not address in any great detail is perhaps the most important in terms of transparency: the type of information to be shared with the regulators from 'systemically important' hedge funds/managers to permit 'macro-prudential' supervision. It does, however, stress that the regulators themselves have to be in a position to use this information effectively. IOSCO is not convinced that, at present, regulators have the resources to do so adequately, thus creating a potential 'moral hazard'.

That said, the IOSCO paper provides a sound analysis and reasonable proposals with regard to the future regulation of hedge funds. In many ways, it strikes a good balance between 'micro-prudential' approaches and 'macro-prudential' considerations. This saves it from falling into the 'fallacy of composition' trap in to which banking supervisors fell: believing that oversight of individual financial institutions can protect the system as a whole.

---

2 See, for example, comments of Segun Aganga (Goldman Sachs) at the European Commission March 2009 hearing on Private Equity and Hedge Funds: http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm

3 Hedge Funds Oversight: Consultation Report by Technical Committee of the International Organisation of Securities Commissions, March 2009 (responses due 30 April 2009)

4 Ibid: Paragraph 109

5 See http://www.hedgefundmatrix.com

6 "In most members' jurisdictions hedge fund advisers and managers are subject to licensing, registration or eligibility requirements." IOSCO Consultation Report, Para 96

Global Asset Management contacts

Asset Management News is produced by experts in their particular field to address important issues affecting the Asset Management industry. If you would like to discuss any aspect of this document, please speak to your usual contact at PricewaterhouseCoopers or one of those listed on these pages.

Global Asset Management Leadership Team

Marc Saluzzi
PricewaterhouseCoopers (Luxembourg)
Global Asset Management Leader
+352 49 48 48 2511
marc.saluzzi@lu.pwc.com

Kees Hage
PricewaterhouseCoopers (Luxembourg)
Global Real Estate Leader
+352 49 48 48 2059
kees.hage@lu.pwc.com

Barry Benjamin
PricewaterhouseCoopers (US)
Americas Asset Management Leader
+1 410 783 7623
barry.p.benjamin@us.pwc.com

Pars Purewal
PricewaterhouseCoopers (UK)
UK Asset Management Leader
+44 20 7212 4738
pars.s.purewal@uk.pwc.com

Brendan McMahon
PricewaterhouseCoopers (Channel Islands)
Global Asset Management
Private Equity Leader
+44 1534 838234
brendan.mcmahon@je.pwc.com

Robert Grome
PricewaterhouseCoopers (Hong Kong)
Asia Pacific Asset Management Leader
+852 2289 1133
robert.grome@hk.pwc.com

David Newton
PricewaterhouseCoopers (UK)
Global Asset Management
Tax Leader
+44 20 7804 2069
david.newton@uk.pwc.com

Tony Artabane
PricewaterhouseCoopers (US)
Global Asset Management
Hedge Funds Leader
+1 646 471 7830
anthony.artabane@us.pwc.com

If you would like to receive copies of this newsletter or would like further information about PricewaterhouseCoopers Asset Management publications, please contact Denise Cook at denise.cook@uk.pwc.com

Editor: Rupert Bruce

pwc.com

© 2009 PricewaterhouseCoopers. All rights reserved. PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

PricewaterhouseCoopers provides industry-focused assurance, tax, and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 155,000 people in 153 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.

This report is produced by experts in their particular field at PricewaterhouseCoopers, to review important issues affecting the financial services industry. It has been prepared for general guidance on matters of interest only, and is not intended to provide specific advice on any matter, nor is it intended to be comprehensive. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers firms do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.