Investment Management and Real Estate

Regulation likely to segment the hedge fund industry

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Regulation likely to segment the hedge fund industry

A series of regulatory initiatives is likely to have the effect of allowing different hedge fund strategies varying degrees of access to investors.

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In response to the crisis in financial markets, several international organisations are proposing a series of amendments to investment management's regulatory framework. In particular, these will have an impact on the activities of some hedge funds.

Broadly speaking, these measures are designed to improve investor protection and financial stability. In the current political climate, there is no doubt that some of the measures proposed will become law.

The practical effect of this is likely to be that the least leveraged strategies such as equity long-short continue to become more widely accepted, but the most highly leveraged hedge funds can only market to a far smaller group of potential investors. Consequently, arbitrage-style funds that typically deploy considerable leverage to profit from small anomalies in securities prices may find they have a far more restricted investor base.

Two main initiatives

There are two main regulatory initiatives. In its November 2008 declaration, the G-20 set out its proposals to stabilise financial markets. As a result of this, the International Organisation of Securities Commissions (IOSCO) formed three task forces to review short selling; unregulated financial entities; unregulated markets and products.

At the same time, the European Commission has released a consultation paper, with a view to amending European hedge fund regulation.

IOSCO's recommendations will be discussed at the next G-20 summit, which will be held in London on 2 April, 2009. Meanwhile, the European Commission has received comments on its consultation paper and is likely to pass new legislation by June 2009.

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The likely impact

While these regulatory initiatives vary in scope, their practical effect is likely to be to create a three-tiered industry structure – within Europe, at least.

- Regulated hedge funds, governed by UCITS III legislation, have weathered the financial crisis well. They are likely to be allowed to continue to be marketed to a wide range of investors.
- Unregulated hedge funds that accept certain limits on their activities will be allowed to market to investors falling into specific definitions of sophistication and net wealth. However, they will have to provide more transparency in their investment strategies, accept a capped level of leverage and comply with a capital requirement in the form of a liquidity buffer.
- Hedge funds that do not comply with these requirements will form the third tier. They will only be able to market to specific groups of people.

Looking forward, this will cause the hedge fund industry to fragment. The less leveraged strategies such as equity long-short will become increasingly accepted by not only the institutional market but also retail investors. More specialist strategies such as macro or distressed debt may remain unregulated and able to market to a similar group of investors as is currently the case. Finally, the highly leveraged arbitrage funds will find the size of their potential market curtailed.

European Commission moves towards regulating hedge funds

In response to a Parliamentary report in September 2008, and against the backdrop of the ongoing crisis, the European Commission consulted on hedge funds activities with a view to potential regulatory action before June 2009. It identified five key areas for stakeholder comment: definition of hedge funds, hedge funds contribution to systemic risk, short-selling, transparency and disclosure to investors and supervisors.

PricewaterhouseCoopers, in responding to the consultation, highlighted, inter alia:

- Hedge funds cannot be defined by unique and distinctive criteria, and yet a clear definition would be necessary for direct regulation of hedge funds. From an EU perspective, prudential requirements for prime brokers which use leverage may provide an alternative, particularly as most hedge funds are not domiciled in the EU.
- The extent and the nature of hedge funds' contributions to the current financial crisis is difficult to determine in the absence of adequate empirical data.
- Tailored but sound risk management practices need to be implemented by all actors in the industry, including fund managers, fund administrators, custodians, etc. Where these practices rely on industry codes, effective enforcement mechanisms need to be in place.
- Regulators would benefit from enhanced disclosure on hedge fund trading strategies, amount of leverage used with the portfolio, types of financial instruments used and exposure concentrations.
- Retail investors should be allowed access to hedge funds provided they are sufficiently informed of the risks they are undertaking.

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