HFSB public response to the IOSCO consultation report on Hedge Fund Oversight

Introduction

The International Organization of Securities Commissions (IOSCO) has launched a wide-ranging public consultation on policy issues arising from the activities of the hedge fund industry, with the aim of developing recommendations on regulatory approaches.

The Hedge Fund Standards Board (HFSB) was set up to act as custodian of the Best Practice Standards published by the Hedge Fund Working Group in 2008 and to promote conformity to the Standards. It is also responsible for ensuring that they are updated and refined as appropriate. Around 50 managers from the UK and abroad – representing over 50% of non US assets under management - have already committed to the process of the HFSB, and more are expected to sign up to the Standards in 2009. The HFSB expects its Hedge Fund Standards to be widely adopted and an increasing number of investors to use the Standards in their due diligence. It is important that policy leaders trust that the HFSB will implement this market based regime with the industry and encourage adoption as well.

Hedge funds, in common with many other market participants, were severely affected by the 2008 crisis and the loss of confidence in markets as a whole. The Hedge Fund Standards Board believes that hedge fund managers play an important role in global markets and is prepared to work with policy makers to help improve the regulatory environment which will enable the industry to fulfil its mission.

The Hedge Fund Standards Board's comments on the questions raised by the IOSCO are as follows:

Consultation responses

Introductory comments

The HFSB agrees with the IOSCO assessment that hedge funds are difficult to define (9.) and that the industry is very diverse in the use of financial instruments with trading activities of hedge funds similar to those undertaken by the proprietary trading areas of large commercial and investment banks (11.). IOSCO also rightfully highlights that hedge fund investors are traditionally institutional or other sophisticated investors. HFSB also agrees with the observation that Hedge Funds enhance market quality (19.).

IOSCO highlights in its assessment that hedge funds can pose risks to the regulatory objectives of maintaining market confidence and protecting investors (64.). However, the HFSB would like to point out that the presence of sophisticated players (such as hedge funds) in the market significantly increases market confidence and indeed their absence might give rise to a loss of confidence (eg in the quality/efficiency of a market) by other investors. A second observation relates to investor protection, where HFSB sees no evidence that the current crisis has given rise to investor protection concerns which required regulatory intervention (ie. regulators stepping in to help investors where they are unable to protect themselves).

Specific consultation questions raised

Do you believe that the FSF work will sufficiently cover the remuneration/ compensation issues / risks? (p.16)

The HFSB welcomes FSF's work on remuneration/compensation issues. It is important to highlight that alignment of interest is already strong in the hedge fund industry and that it is ultimately the task of sophisticated investors to ensure managers act in investors' best interest via adequate incentive structures (also see assessment in table 1 below). The crisis has already led to renegotiations of terms and compensation structures in some hedge funds, demonstrating that the market based process functions in this area.

Do you believe that Chapter 1 appropriately identifies and describes the relevant risks / issues associated with hedge funds and their operations? (p.20)

IOSCO highlights a series of risks that it says hedge funds pose to capital markets. The HFSB believes that IOSCO has focused on the right issues in its report and the HFSB has provided its best assessment of each of these areas in the table below. In particular, the HFSB believes that it is very important to assess

a) whether stakeholders that are ultimately affected by these risks are capable of addressing /managing them properly, and

b) if there are other issues that might need to be addressed by regulators (because the market fails to address them properly, in particular if they represent a negative externality which cannot be addressed by market participants individually).

Table 1: Assessment framework of issues raised by IOSCO

	Factor	Relevant to which stakeholder?	What is the issue?	Can it be addressed by the relevant stakeholder, and how?	What else is needed (via regulatory intervention)?	Need for action by regulators
Inherent risks	Lack of transparency, reporting	Sophisticated investors	Are investors doing adequate due diligence?	Yes, it can be addressed. Investors should not invest if information provision is not satisfactory. Investors can require managers to sign up to commonly accepted industry standards such as those of the HFSB, which require a higher level of disclosure.	Unclear. There is no obvious negative externality that needs to be addressed.	LOW
		Counterparty	Are counterparties (ie banks) taking excessive risks or risks they do not understand?	Yes, it can be addressed. Banks are sophisticated in their risk management and are capable of carrying out risk assessments and are subject to regulatory capital requirements in relation to these risks. If information provision by the fund is not sufficient, they should not take these risks.	Unclear. There is no evidence that risk taking of banks has been excessive, and the reduction in leverage in the HF industry during the crisis/increase in haircuts and collateral requirements indicates that banks have actually adjusted risk taking.	LOW-MEDIUM
		Regulator	Do HFs pose a threat to the systemically relevant banking sector? *[HFSB does not see evidence that HFs pose a threat to financial stability. However, it is important that regulators are capable of assessing this.]*	Yes, it can be addressed. Some regulators already systematically collect information on risk taking of banks vis a vis HF (eg UK FSA Prime Broker survey).	International cooperation between regulators to assess risk taking by the banking sector vis a vis hedge funds.	MEDIUM-HIGH
	Conflicts relating to manager remuneration *[It is important to highlight that risk alignment in the HF industry has been*	Sophisticated investor	Can investors instil sufficient control to avoid risk taking at the expense of investors?	Yes, it can be addressed. Investors should assess the alignment of interest between the manager and the investor (via compensation structures) prior to investing and ensure that it meets their requirements. Investors should require ongoing disclosure on risk characteristics of the fund and withdraw their monies if risk taking deviates from their risk appetite. Investors can require managers to sign up to commonly accepted industry standards such as	Unclear. There is no negative externality that needs to be addressed by regulators in the HF sector.	LOW

	Factor	Relevant to which stakeholder?	What is the issue?	Can it be addressed by the relevant stakeholder, and how?	What else is needed (via regulatory intervention)?	Need for action by regulators
	historically much better than in other areas, such as the banking sector, since HF managers invest alongside their clients.]			those of the HFSB, which recommend ongoing disclosure, as well as up front disclosure of the risk profile of the fund.		
		Counterparty	Do counterparties have sufficient insight to prevent risk taking at their expense?	Yes, it can be addressed. Counterparties such as prime brokers already monitor their exposure on a daily basis.	Unclear. There is no negative externality that needs to be addressed by regulators in the HF sector.	LOW
		Regulator	Do incentive structures in HFs and resulting risk taking / behaviour create systemic risks/create market instability? *[HFSB has no evidence that incentive structures in HFs ultimately lead to systemic risks or can create market instability.]*	Unclear what regulators should address in the context of hedge funds. This is an area where enforcement of good standards can be easily delegated to the market place (ie investors).	Unclear. There is no negative externality that needs to be addressed by regulators in the HF sector.	VERY LOW
Risks highlighted by recent market events	Financial instability due to leverage (i.e. via HF failure[1]; ii. disorderly pricing[2])	Sophisticated investor	Are investors capable of monitoring risk taking (incl. leverage) of managers?	Yes, it can be addressed. Investors should require adequate disclosure in relation to risk (as per above). Investors should require managers to commit to the Hedge Fund Standards.	Unclear. Significant investor losses are a possible outcome of risk taking and do not represent market failure.	LOW
		Counterparty	Are counterparties capable of monitoring risk taking (incl. leverage) of managers?	Yes, it can be addressed. Counterparties (eg banks) are sophisticated in their risk management, are capable of carrying out risk assessment and are subject to regulatory capital requirements in relation to these risks (as per above).	Unclear. If regulators believe that risk taking by banks vis à vis hedge funds is not adequately managed, oversight on the banking sector would need to be strengthened.	LOW

[1] It is important to highlight in this context that HF leverage is low (on average 1.4, but varying by strategy, for example up to 10 for relative value strategies). This compares to leverage of 30 (and in some instances up to 60) for banks.

[2] HFSB sees no evidence of disorderly pricing during the crisis in relation to HF activity.

	Factor	Relevant to which stakeholder?	What is the issue?	Can it be addressed by the relevant stakeholder, and how?	What else is needed (via regulatory intervention)?	Need for action by regulators
		Regulator	Can risk taking (incl. leverage) by HF pose a threat to the systemically relevant banking sector or cause disorderly markets? *[HFSB does not see evidence that HF pose a threat to financial stability. However, it is important that regulators are capable of assessing this.]*	Yes, it can be addressed. Some regulators already systematically collect information on risk taking/leverage provision of banks vis a vis HF (eg UK FSA Prime Broker survey).	International cooperation between regulators to assess the risk taking of the banking sector vis a vis hedge funds.	MEDIUM-HIGH
	Market disruption due to market behaviour and trading/ investment strategy risk	Sophisticated investors	Can investors help mitigate the risk of disorderly markets?	Yes, it can be addressed, by ensuring that individual risk taking is in line with their risk appetite.	Unclear.	LOW
		Counterparties	Can counterparties help mitigate the risk of disorderly markets?	Yes, it can be addressed, by ensuring that individual risk taking is in line with their risk appetite.	Unclear.	LOW
		Regulators	Can the failure of a large HF/FOF cause market disruptions, exacerbate volatility, undermine price discovery.	Yes, it can be addressed, by assessing the quality of the risk management of managers and assessing the risk taking of large/systemically significant managers. *Some regulators (such as the UK FSA) already address exactly these issues.*	Registration and supervision of managers. Select data gathering where activities are systemically relevant. *Already in place in some jurisdictions.*	MEDIUM

There are several conclusions that can be drawn from this analysis:

1. The primary concern should be to strengthen the market-based process involving investors and counterparties:

   The interests of investors and counterparties are closely aligned with those of hedge fund managers, and they are best suited to scrutinise managers in relation to risk, valuation, governance and conduct issues and to require the disclosure they need to make adequate investment decisions and provision of credit/leverage. The HFSB feels that this approach is extremely effective, since it relies on those who have most at stake. In particular investor's allocations are the most powerful incentive for managers to improve standards. This process helps to reinforce the Darwinian process of weeding out underperformers and those who do not meet industry best practice. This mechanism leaves no room for complacency, either on the side of investors (who need to perform due diligence), or on the part of managers (who will be eliminated if they do not meet the standards). Equally important, there is no false comfort (which a regulatory regime seeking to protect investors can introduce to the system).

2. HFSB agrees with IOSCO that regulators need robust regimes.

   HFSB believes that both registration by the managers and adequate supervisory powers for the regulators are required. These powers should focus on compliance with regulatory requirements, market integrity and financial stability. However, HFSB does not see a need for significant regulatory focus on investor protection given the sophisticated nature of hedge fund investors:

   - Investor protection regulation in this area provides little- if any - incremental benefit beyond the scrutiny applied by investors.
   - It might even give rise to moral hazard since it might create false comfort, in areas where diligent assessment by investors is required.
   - In this context, it is also important to highlight that retail access to Hedge Funds is only provided via regulated products such as UCITS, which provide the incremental protection element that is absolutely needed in the retail context.

3. HFSB agrees that regulators need to assess their incremental information needs for systemic risk purposes.

   Although HFSB believes that the activity of the hedge fund industry does not currently give rise to systemic concerns, it is important that regulators are in a position to carry out this assessment to identify any changes in the systemic nature of the industry. In particular, this includes frequent assessments of risk taking of the systemically relevant banking sector vis a vis hedge funds, and ensuring that risk monitoring at prime brokers is fit for purpose. Where a manager/fund is systemically relevant, it is entirely appropriate that regulators should have a role in ensuring that the management of risk and operations is fit for purpose. Regulators should also be capable of collecting data if deemed relevant.

Do you share the views that this type of information should be obtained from hedge fund counterparties? Do you support the call for strong risk management controls at these entities? (p. 33)

HFSB agrees that counterparties should have strong risk management capabilities and that regulators should collect information on risk taking of banks vis a vis hedge funds, which are the main source and transmission mechanism of systemic risk. Such a regime is already in place in the UK, and HFSB would be happy to work with systemic risk regulators to enhance such existing approaches on a global basis.

Is direct regulation of hedge fund managers the best approach to addressing investor protection and systemic risk concerns raised by hedge funds? (p. 33)

HFSB is comfortable with direct manager regulation and supervision with a set of minimum requirements applicable to asset managers (in general), but combined with a market-based regime (such as the HFSB) which ensures that managers adhere to the high standards. Ultimately, it is investors who provide the most extensive and detailed scrutiny that is required to make managers commit to high standards. This mechanism has been very powerful in the past, and the HFSB regime, which involves both managers and investors, will help this process going forward.

Do you support the need for progress towards a consistent regulatory approach to hedge fund managers? (p. 33)

HFSB already operates in an environment (EU/UK) which has a strong and tested regulatory approach to (Hedge) Fund Managers. This can serve as a blue print for jurisdictions with no such registration/oversight requirements.

Do you agree with such a risk-based approach? What should determine whether a fund manager (or their underlying funds) are systemically important? (p. 33)

HFSB agrees with a risk-based approach, which helps to focus regulatory efforts on the most relevant managers. The HFSB agrees that it is important that systemic risk regulators are in a position to assess if a manager and its activities could have systemic implications. Factors could include the size (AUM), leverage and existence of asset/liability and liquidity mismatches.

Do you agree with the proposed list of information to be provided at authorisation/ registration? (p. 34)

HFSB has no objection to information provision at authorisation/registration. HFSB would hope that the regime would not be onerous and focus on data relevant for financial stability purposes and market integrity. The Hedge Fund Standards already require disclosure of many of the aspects highlighted by IOSCO to investors.

Do you agree with the proposed approach to ongoing supervision? (p. 36)

HFSB believes that all areas suggested by IOSCO are relevant, and it is important to highlight that all of these aspects are embedded in the Hedge Fund Standards and generally required by sophisticated investors. It is important that the requirements highlighted by IOSCO apply not only to Hedge Fund

Managers, but any type of asset management activity (including long only asset management). To avoid overly prescriptive regulation, HFSB would like to encourage IOSCO and other regulators to assess the HFSB regime as the market based extension of regulation, which is ultimately enforced by investors (and also the regulator, in instances where a manager misrepresents or otherwise fails to meet its commitment to investors).

Is direct regulation of hedge funds the best approach to addressing investor protection and systemic risk concerns raised by hedge funds? What do you see as the benefits of direct regulation of the hedge fund itself? What requirements should apply at this level? What type of information do you believe the regulator needs to have about the fund itself to allow for adequate oversight? At which frequency should the information be available? (p. 36)

HFSB does not see evidence that direct regulation of hedge funds is required to protect sophisticated investors. It is very often the case that investors on purpose chose to invest in non regulated products/vehicles just because they want to ensure that managers are not restricted in their asset management activities. Those investors who prefer "regulated products" already have the choice to invest in hedge funds managed in UCITS and other regulated structures, providing the enhanced protection that in particular retail investors require.

As far as systemic risk is concerned, the most important issue is that systemic risk regulators can gather information on the risk taking of systemically relevant banks in relation to hedge funds (similarly to information that regulators can gather on banks' risk taking in other areas of the economy and financial markets). Regulators should also be in a position to gather information on the activities of large fund managers, including the quality of risk management and operations, as well as the nature of their activities. HFSB does not see a strong case for direct fund regulation for systemic reasons nor does it believe it is necessary to impose restrictions at the product level, such as, for example, leverage limits. HFSB believes that such restrictions could even have a negative impact on markets. If for example, due to market fluctuations, funds approached such a "threshold" and were forced to unwind positions that they would otherwise not unwind, rather than stabilising markets, leverage limits could introduce additional volatility and artificial stress. It is important to remember, that it is primarily the investors who bear any potential losses arising from risk taking by managers, and this by itself is not a systemic concern. Secondly, banks take risks, but they are again sophisticated enough to assess their risk taking, and they usually engage only in highly collateralised lending.

Do you agree that IOSCO should support the development of a set of globally consistent industry best practice standards and their subsequent monitoring? How do you believe the take up / compliance could be monitored? (p. 37)

The HFSB provides a platform involving both investors and managers to carry forward the development of industry standards. It has an existing body of Hedge Funds Standards in place, with around 50 managers from all over the world committing to these Standards; these managers represent over 50% of assets under management outside the US. However, it is important to highlight that, while HFSB monitors the Standards, it does not serve as a regulator and does not enforce them. In a sophisticated market place, this is left to investors to drive conformity with the HFSB standards. HFSB believes that this is a very powerful mechanism, since the interests of investors are closely aligned with those of the managers. Investors can vote with their money (ie withdrawing monies from managers who do not meet the standards or underperform), and thereby ultimately drive the Darwinian process that sees the weak managers eliminated and continuous improvement of Standards. As managers commit publicly to the Standards, these also become binding, in the sense that not complying with them becomes a form of misrepresentation, leading to sanctions by regulators or the courts.

Ultimately, a dual regime involving registration and supervision of the manager by the regulator, as well as industry Standards (such as the HFSB Standards), enforced by sophisticated investors is the most robust approach. This should be complemented by systemic risk oversight of bank's risk taking vis a vis hedge funds and additional data gathering from the largest managers.

HFSB stands ready to play a constructive role globally, and is already working closely with the PWG as well as other industry bodies to develop global standards, as proposed under the G20 process.

Do you have any comments on the proposals made? (p.37)
HFSB agrees that there should be further international cooperation among regulators to enhance understanding of the hedge funds industry, including strengthening the regimes to detect fraudulent market behaviour and activities. Finally, HFSB agrees that managers should be capable of fully assessing the risks of the underlying funds they manage.