UK legal and regulatory developments

Hedge funds: A discussion of risk and regulatory engagement

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INTRODUCTION

In June 2005, the Financial Services Authority (FSA) published a discussion paper entitled 'Hedge Funds: A Discussion of Risk and Regulatory Engagement', which, among other things, contains the FSA's current assessment of the risk posed by hedge funds to the FSA's statutory objectives and sets out the steps that the FSA is considering taking with a view to mitigating those risks. The discussion paper is significant for a number of reasons. First, the fact that the FSA has decided to publish such a paper three years after the publication of another hedge fund-specific discussion paper¹ demonstrates the importance that the FSA attaches to this sector of financial services. Secondly, in setting out what the FSA perceives to be the major risks to which hedge funds give rise,

the paper affords those engaged in this sector an opportunity to assess how well they are managing those risks. Thirdly, the paper provides an insight into the regulatory strategies that the FSA and its counterparts in other jurisdictions are thinking of employing to deal with hedge fund risk. Finally, in inviting comments on the FSA's proposals for risk mitigation, the paper gives hedge fund industry participants an opportunity to influence future regulatory strategy in this area. The purpose of this paper is to provide a summary of, and commentary on, the risks identified by the FSA, and its proposals for managing those risks.

WHY IS THE FSA CONCERNED?

In the introduction to the discussion paper, the FSA sets out its reasons for

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publishing such a paper. Among the reasons cited are:

- the perceived importance of hedge funds by investors, market participants, commentators and regulators
- recent growth in the sector resulting in an increasingly significant role for hedge funds in the provision of market liquidity and revenues to investment banks
- the evolution of the typical investor base to include significant pension fund exposure
- indications that a number of investment managers intend to launch onshore regulated products using some of the investment techniques typically employed by hedge fund managers.

As the hedge fund sector grows, the greater is the risk it poses to the FSA's statutory objectives of market confidence, consumer protection and the reduction of financial crime.² The challenge of managing these risks is increased by the complex and dispersed nature of hedge fund business arrangements, which means that, typically, as the hedge funds themselves and the administrators are based in offshore jurisdictions, the FSA's regulatory jurisdiction is confined to hedge fund investment managers and prime brokers based in the UK.

THE RISKS

For the purposes of the discussion paper, the FSA groups the risks posed by hedge funds into four categories

- risks to financial stability and market confidence
- risks to market cleanliness
- risks to the FSA's financial crime objective
- risks to the FSA's consumer protection objective.

RISKS TO FINANCIAL STABILITY AND MARKET CONFIDENCE

Here, the FSA is concerned with risks that could arise when the failure or significant distress of a hedge fund or cluster of hedge funds causes disruption to the financial system through its impact on counterparties or markets (financial stability risk) and impairs the depth, liquidity or transparency of markets or damages the efficiency of the price formation, trade execution and settlement process (market confidence risk). The paper identifies and analyses a number of key specific risks falling under this generic heading namely:

- serious market disruption and erosion of confidence
- liquidity disruption leading to disorderly markets
- insufficient information to inform regulatory action
- control issues
- operational risk
- risk management
- valuation weaknesses.

Serious market disruption and erosion of confidence

As the near-collapse of Long Term Capital

Management (LTCM) in 1998 demonstrated, the failure or significant distress of an individual fund or cluster of funds can cause serious market disruption and erode confidence in the financial strength either of other hedge funds or of firms which are counterparties to the fund or funds. In the light of enhanced risk management by hedge fund counterparties since the LTCM episode, the FSA is of the opinion that the risk of an individual fund posing a threat to the financial system on the scale of LTCM has significantly diminished. The FSA is concerned, however, that financial stability might be threatened if a group of medium-sized funds were simultaneously to encounter difficulties, either because they were following similar strategies or because of a contagious collapse in confidence. This concern was heightened by the impact on the hedge fund sector and related market participants of the credit rating downgrade of General Motors and Ford in 2005. Although no financial stability event developed as a result of those downgrades, hedge funds pursuing similar strategies incurred losses which led to investor redemptions and enforced liquidation of assets. According to the FSA, the potential threats to financial stability arising in single hedge funds or clusters of hedge funds raise the question of whether more comprehensive monitoring is desirable and possible.

In addition to the risk to financial stability posed by individual funds or clusters of funds, the FSA's discussion paper expresses concern about the risk to financial stability posed by low probability outcomes

— so-called 'long tail events', such as the Russian default crisis which occurred in the summer of 1998 — which may not be captured by value at risk (VaR) risk management models relying on distributions of outcomes. The FSA is keen to see the development of stress tests which take account of extreme but plausible scenarios and which capture new risks which may have arisen as a result of market changes rather than being simply backward-looking.

In the light of the fact that financial stability risks are likely to affect firms or markets in more than one jurisdiction, the FSA is of the view that these risks are best mitigated through regulatory action that is coordinated globally, for example by regulators sharing findings through global fora such as the Financial Stability Forum (FSF). It would appear that this view is shared by regulators in other jurisdictions, as one of the action points arising from the FSF meeting in Tokyo in March 2005 was that regulators were encouraged to carry out and share 'horizontal reviews' of key financial institutions' readiness to deal with changes in the economic and financial environment, and that such reviews should cover institutions' exposures to rising interest rates and risk premiums, as well as the nature and management of their exposures to hedge funds and private equity funds. Given the desire on the part of regulators in different jurisdictions to share information of this nature, increased regulatory scrutiny of the hedge fund industry appears inevitable.

At a domestic level, the FSA has taken a number of actions aimed at mitigating risk in the hedge fund sector. These steps

include the cultivation of informal, non-supervisory relationships with a number of major hedge fund managers and prime brokers with a view to increasing understanding of the hedge fund industry and its inherent risks. In addition, the FSA has conducted a 'hedge funds as counterparties' survey aimed at

- enhancing the FSA's understanding of the hedge fund/prime brokerage sectors;
- gauging the risk appetite of both credit providers and hedge fund; and
- identifying any very large highly leveraged funds.

According to the FSA, the survey enabled it to establish the current strengths and weaknesses of counterparty risk management. Among the weaknesses identified by the FSA were the following:

- less stringent risk management standards among new entrants to the prime broker/finance provider field
- difficulties in aggregating prime brokerage and non-prime brokerage exposures
- failure on the part of some firms to conduct on-site visits for all hedge fund counterparties.

Significantly for those firms with hedge funds as counterparties, the FSA intends to repeat the data collection exercise carried out as part of the survey on a six-monthly basis. Those firms falling within the scope of this data collection exercise should review their counterparty risk management processes with a view to ensuring that they are sufficiently robust both to manage

counterparty risk and to withstand the FSA's scrutiny.

Risks to market confidence

Unsurprisingly, a review of the market impact of hedge funds undertaken by the FSA in the Spring of 2005 found that hedge funds are playing an increasingly important role in financial markets. The discussion paper points out that, in some ways, this is a positive development in that they can significantly enhance market liquidity and market efficiency. The paper also states, however, that the employment of leverage by hedge funds augments risk and that their innovative practices may test the boundaries of acceptable market practice and alter market dynamics. As a result, the FSA is of the view that, in certain circumstances, hedge funds may have a detrimental impact on the orderly functioning of markets.

In stating that, on the one hand, hedge fund activity may make a positive contribution to market efficiency and on the other, that it may have a detrimental effect on market orderliness, the FSA does not make a compelling case for special regulatory treatment of hedge funds, as the same point could be made about a variety of financial market participants and activities. The FSA also states, however, that it believes that, in the case of larger hedge funds with \$1bn of assets under management, the potential exists for that fund to have a far greater market impact than a traditional asset manager with \$1bn under management as hedge funds have the following characteristics:

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- high transaction volume/fund turnover;
 - concentrations in less liquid markets;
 - concentrations in innovative/complex products;
 - concentrations in high profile corporate events/market movements; and
 - use of risk augmenting techniques such as leverage.

According to the FSA, large funds are capable of having a market impact as significant as that of investment bank proprietary trading desks. This is viewed as a particular cause for concern in the light of the fact that hedge fund management businesses are growing rapidly and are subject to far less regulatory scrutiny than would normally be the case for investment banks.

Liquidity disruption leading to disorderly markets

The discussion paper cites liquidity risk as one of the risks that may result in hedge fund activity leading to disorderly markets. There are a number of aspects to this risk. First, as the incidence of hedge funds collectively making concentrated investments in complex specialist financial instruments and particular market segments increases, there is a risk of market liquidity disappearing if fund managers choose to exit the position or market at the same time. This problem could be particularly acute for complex assets, where liquidity may not be as great as that found in more traditional markets.

Secondly, liquidity risk is heightened in the case of highly leveraged funds, as any liquidity crisis could be made more acute by

virtue of the fact that such an event could lead to an increase in financing costs/margin payments or the cutting of credit lines, which, in turn, might force the fund into selling assets. Thirdly, there is the issue of investor-related liquidity risk which is the risk that fund investors redeem their investments in the fund and force hedge fund managers to sell the fund's assets. The discussion paper refers to the existence of an increasing number of managed accounts and side letters granting enhanced investor liquidity and states that this trend may be growing as hedge funds become increasingly reliant on institutional investors who make enhanced liquidity a condition of investing in the fund. Clearly, the easier it is for an investor to make redemptions, the greater the chance of a liquidity mismatch between investments in the fund and the assets in which the fund itself invests.

Opacity

Another issue discussed by the FSA relates to transparency in the hedge fund environment. The FSA appears to be relatively content with transparency from the perspective of investors in that the paper states that due diligence by investors is increasing in quality, led by some well-run funds of funds. In addition, the paper states that many hedge fund managers appear to be producing relatively detailed newsletters for investors and that general transparency levels are far greater than those observed by the FSA in relation to investment bank proprietary trading desks. From the regulatory perspective, however, the FSA is less happy because enhanced transparency for investors has not increased

transparency for regulators. According to the FSA, ‘will not ... facilitate market supervision unless a regime is created that allows us to gather information in a systematic fashion and then subject it to ongoing analysis’.

Control issues

Control issues represent another of the key risks identified by the FSA. The need to have controls in place contributes to costs and may make it harder for fund managers to generate sufficient returns to remain in business. A further control environment issue relates to the FSA’s concern that the former investment bank star traders who typically set up hedge fund management firms may lack the all-round managerial experience necessary to create an effective control infrastructure.

Operational risk

Another risk related to control issues is the operational risk that arises from the failure of the operational infrastructure to keep pace with rapid growth in areas such as the number of funds, investor base and jurisdictional spread. As a result, there is a danger of late trade confirmations and non-notified trade assignments and novations.

Risk management

According to the discussion paper, the FSA did not observe any material weaknesses in the risk management techniques being employed in the hedge fund sector, although there was some concern that portfolio risk management in multi-strategy funds is a particular challenge, as the

intrinsic risks vary between the strategies. Multi-strategy fund managers tend to have complex databases of positions and risk data, as no single metric works for all their risks. As a result, managers are faced with the challenge of considering overall risk according to a number of non-comparable metrics. The FSA also highlighted concerns relating to the management of risk by investment banks dealing with hedge funds. Specifically, the paper expresses the view that some investment banks could improve their ability to assess total risk exposures where the firm has a combination of trading, prime brokerage and investment relationships with hedge funds.

Valuation weaknesses

The final area of risk that the paper deals with under the heading of risks to financial stability and market confidence concerns valuation weaknesses. The FSA believes that there are a considerable number of operational risks inherent in the valuation of hedge fund assets which may affect investors’ ability to assess hedge fund manager performance accurately and therefore take informed investment decisions. The main problem as far as valuation is concerned is that many hedge funds invest in illiquid or complex assets for which there is no public screen price. Administrators who are valuing such assets are forced to rely upon a combination of valuation methodologies that raise doubts about whether the valuations are truly independent. These include:

- counterparty quotes;
- valuation models (frequently developed

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- by the hedge fund management business itself); and
- direct valuations from the hedge fund manager.

THE FSA'S PROPOSED RESPONSE TO RISKS TO FINANCIAL STABILITY AND MARKET CONFIDENCE

The discussion paper contains a number of proposed regulatory responses to the risks posed by hedge fund activity to financial stability and market confidence and invites comments on these proposals. A summary of these proposals is set out below.

Distinguishing hedge fund managers from other discretionary managers/advisers

Based on its assessment that hedge fund managers have a different risk profile to other discretionary investment managers and advisers, the FSA proposes that it may be beneficial to distinguish hedge fund managers clearly for the purposes of regulatory oversight. According to the FSA, this distinction could be achieved in one of two ways:

- (1) the creation of a distinct hedge fund management regulatory activity under the Financial Services and Markets Act 2000 (FSMA), obliging firms to seek a separate permission before being able to carry on the regulated activity of hedge fund management, or
- (2) making hedge fund management a notifiable event so that a firm already authorised to carry on investment management or advice would be able to

undertake hedge fund management as soon as the notification had been made.

Of these two options, the second is preferred on the grounds that it would avoid the lengthy process of having to draft, agree and implement legislative amendments.

Enhanced supervisory oversight

The FSA has already increased its market surveillance through the monitoring of hedge fund counterparties. The paper states that consideration could be given to building upon this work by enhancing surveillance of hedge fund managers themselves. Although the FSA poses this suggestion as a matter for consideration and invites comment upon it, it would appear that, to some extent at least, the FSA has already begun this process: the paper refers to the creation of a centre of hedge fund expertise within the FSA's Wholesale Business Unit, which will be responsible for relationship management of those hedge fund managers whose funds and business models have a significant market impact.

Enhanced data collection

The paper contains the statement that: 'Information gathering and analysis in a systematic fashion will be critical to any effort to mitigate the risks associated with market quality.' Although the FSA is at pains to point out that it would seek to limit the burden imposed by enhanced data collection by, among other things, keeping the data requirements to a minimum and not duplicating data to be gathered from prime brokers, there can

be little doubt that, if the proposal were to be implemented, the burden on fund managers would be significant. According to the paper, fund managers could be asked to provide the following information:

- the prospectus and (where available) marketing pack for each fund;
- the strategy buckets of each fund;
- the valuation of the assets under management of each fund, both from the manager's internal systems and from any external administrator;
- gross long and gross short exposure per fund;
- any profit and loss volatility target per fund;
- the monthly return per fund;
- performance fees per fund in the reporting period;
- management fees per fund in the reporting period;
- the number and value of transactions in the reporting period; and
- the total commission paid in the reporting period.

Revised impact metrics

The FSA suggests that data gathered as part of any enhanced data collection project could be assessed according to pre-determined impact metrics (revised to focus on market impact) with a view to determining the appropriate degree of regulatory oversight. Such metrics would take account of different liquidity profiles of the markets in which the hedge fund manager was active and might be based upon factors such as:

- size — assets under management (weighted by strategy);
- risk appetite — gross exposure;
- liquidity provision — transaction volume; and
- counterparty significance — commission paid.

Encouraging improvements in disclosure and due diligence

The FSA is of the view that its regulatory approach cannot remove the need for considerable due diligence to be undertaken by investors and counterparties.

Notwithstanding this, the discussion paper queries whether the FSA should help the industry to mitigate the risk of inadequate due diligence and disclosure by encouraging industry initiatives to improve disclosure and due diligence standards.

Risk mitigation options in relation to valuation

In the light of concerns relating to the independence of valuations referred to above, the FSA believes that attempts to stimulate improvements in the quality and independence of hedge fund valuations are justified. The suggestions aimed at achieving this are

- a global code of conduct along the lines of the IOSCO Code of Conduct Fundamentals with respect to credit rating agencies
- that the FSA works with industry bodies and firms to stimulate the development of national criteria that could raise standards
- that the FSA engages with market

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- participants to encourage the development of a market solution that would provide an independent valuation service
 - the imposition of a rule on FSA authorised fund managers requiring them to ensure that any funds they manage are subject to robust independent valuation
 - the issuing by the FSA of a ‘health warning’ on its concerns about hedge fund valuations.

RISKS TO MARKET CLEANLINESS

During the course of its review of the market impact of hedge funds, the FSA received comments from some firms which raised concerns that hedge funds were, at least, pushing at the boundaries of acceptable practice in relation to trading based on non-public information. In particular, there were questions about practices by which the hedge fund management business might learn enough information about an impending corporate event to pre-position itself before being formally brought inside. Such behaviour could amount to the criminal offence of insider dealing under Part V of the Criminal Justice Act 1993 and market abuse (insider dealing) within the meaning of s. 118 of the FSMA. In addition, the FSA concluded that hedge fund managers may also be testing the limits of acceptable practice in relation to market manipulation in that some managers might be using their size or starting market rumours to move the market deliberately in order to benefit from

advantageous prices. Like insider dealing, spreading false and misleading information and creating market distortions are breaches of the market abuse regime.

The FSA also expressed concerns about the overall awareness of the market abuse regime in hedge fund managers. In some instances, considerable dependence was placed on training received by staff in prior positions at other firms. In addition, there appeared to be a significant degree of reliance in some hedge fund managers on outside consultants who draft compliance manuals and procedures, without clear evidence of significant firm buy-in to the results.

In the discussion paper, the FSA sets out a number of proposals for dealing with the risk of hedge funds committing market abuse. These include:

- requiring firms who make transaction reports under chapter 17 of the FSA’s Supervision Manual (SUP 17) to report the hedge fund manager as the counterparty to the transaction;³
- redevelopment of the FSA’s transaction monitoring system to improve the FSA’s ability to identify market abuse; and
- proactive market conduct surveillance through the undertaking of thematic reviews such as the review of credit portfolio trading and the use of non-public information.

Clearly, the FSA will not tolerate the involvement of hedge funds in market abuse and, in the light of the comments made in the discussion paper, it is safe to assume that this is an area which the

FSA will continue to keep under close scrutiny. Since the publication of the discussion paper, the Market Abuse Directive⁴ has been implemented in the UK. As well as leading to changes to the market abuse regime in s. 118 FSMA, this has resulted in the introduction of a requirement on FSA authorised firms who arrange or execute a transaction with or for a client in a qualifying investment admitted to trading on a prescribed market and who have reasonable grounds to suspect that the transaction might constitute market abuse to notify the FSA without delay.⁵ The introduction of this reporting requirement, together with the FSA's concerns about the risks posed by hedge funds to market cleanliness, means that those firms dealing with hedge funds will need to ensure that they take the obligation to report suspicions of market abuse very seriously. Similarly, hedge fund managers should take steps to ensure that they are fully aware of and are abiding by their legal and regulatory obligations in this area. Among other things, this will involve acting upon the FSA's wish to see better market abuse training and ensuring that such training becomes embedded in the control environment on an ongoing basis.

RISKS TO THE FSA'S FINANCIAL CRIME OBJECTIVE

The discussion paper identifies two key risks to the FSA's statutory objective to reduce financial crime; namely, the risk of hedge fund managers committing fraud and the risk that hedge fund managers are not

fulfilling anti-money laundering (AML) responsibilities adequately.

Risk of hedge fund managers committing fraud

In the US, the Securities and Exchange Commission has pursued more than fifty cases against US-based managers that defrauded hedge fund investors or used the fund to defraud others in amounts estimated at \$1.1bn over a five-year period. To date, the experience of fraud among US-managed hedge funds has not been a problem for the UK-managed funds, partly as a result of the fact that, in the UK, hedge fund managers are required to be FSA authorised. This fact, together with the fact that UK investors in hedge funds are generally sophisticated, led to the FSA concluding that, 'It is difficult to justify mitigating fraud in hedge funds as a priority for the FSA from its consumer protection objective.' As a result, the FSA does not propose to devote scarce regulatory resources to supplement the due diligence undertaken by both investors and counterparties, although it might encourage the industry to raise its own standards.

Risk of hedge fund managers not fulfilling AML responsibilities adequately

The legal relationship between hedge funds and managers is structured in such a way that the fund is a client of the UK hedge fund manager and, as such, the fund manager must comply with the obligation under article 4 of the Money Laundering Regulations 2003 to obtain evidence of the identity of the fund. The fund itself will be responsible for

identifying investors in the fund, and commonly delegates this responsibility to a fund administration company. Usually, both the fund and the administration company it employs are located in non-UK jurisdictions, so the regulatory oversight for them lies not with the FSA, but with other regulators.

According to the discussion paper, a recent FSA project which looked at the AML policies, procedures and controls of a small number of UK authorised hedge fund managers concluded that those visited as part of the project were sufficiently aware of, and had procedures in place to meet, their AML legal and regulatory obligations. Consequently, the paper does not contain specific proposals for regulatory risk mitigation in this area.

RISKS TO THE FSA'S CONSUMER PROTECTION OBJECTIVE

The specific risk identified by the FSA in relation to its consumer protection objective relates to the potential for inadequate management of conflicts of interests by pension fund consultants who advise pension fund trustees to allocate some of the scheme's assets to hedge fund investments. Specifically, the FSA is concerned that some consultants are setting up hedge fund-of-funds advisers and receive regular fees from funds of hedge funds. This means that there could be an incentive for consultants to advise allocation to hedge funds on the basis that they will receive additional fees. As advising pension funds on asset allocation is not a regulated

activity, the FSA proposes to deal with this issue through dialogue with the Pensions Regulator.

CONCLUSIONS

Hedge funds are very much part of the current regulatory agenda and a number of regulatory initiatives are already in place, both domestically and globally, to mitigate hedge fund-related risks. Consequently those involved in this sector can expect to see increased regulatory scrutiny. From the UK perspective, both FSA-authorised hedge fund managers and firms with hedge funds as counterparties should examine their compliance and risk management controls with a view to ensuring that they are sufficiently robust to manage the risks identified by the FSA in the discussion paper.

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This legal and regulatory roundup is not intended to be a comprehensive guide to the subject matter it covers, or to provide legal advice. For further information, please contact Jonathan Marsh at Hunton & Williams: jmarsh@hunton.com

References and Notes

- (1) 'Hedge Funds and the FSA', FSA, Discussion Paper 16, August (2002).
- (2) The Financial Services and Markets Act 2000, sub-section 2(2).
- (3) Currently, as the legal counterparty to the transaction is the hedge fund itself, it, not the manager, is reported as the counterparty.
- (4) Directive 2003/6/EC.
- (5) SUP 15.10.2.