

# Regulation of the Hedge Fund Industry

How effective is international regulation of hedge funds? And what should the industry expect in the future? Asks **Martin Kelly of Aquin**

## INCONSISTENCY AND FRAGMENTATION

Internationally, the regulatory authorities are inconsistent in their approach to regulating hedge fund industry, perhaps because the cross-border structures typically used by hedge funds outstrip the regulatory remit of each and all nationally based regulators to varying degrees.

## HEDGE FUNDS

There is no failsafe definition of a hedge fund, beyond the broadest descriptions of intent and the typical legal structures and incentive devices they use. There are no external restrictions determining what instruments or investment ideas a hedge fund may use, or with what levels of concentration or gearing. This is contractually agreed between the fund and the investment manager.

It is perhaps this absence of regulatory prescription that enables 'hedge funds' to be classed together.

## STRUCTURE

The principle contracting entity in a hedge fund structure is nearly always outside the jurisdiction of the investment managers' regulator. This severely limits the effectiveness of the regulator and its remit to only to those activities undertaken within its geographic scope.

## SEC AND FSA

The US and UK regulators have both taken strides to enhance their approaches to the hedge fund sector. The main risks they seek to address include fraud, market abuse and excessive risk taking. MiFID also introduces new regulatory requirements for all European investment managers, including hedge

fund managers. In the UK, for the first time, hedge fund managers will be subject to best execution and suitability requirements as well as increased conflicts of interest and risk disclosure obligations.

The FSA, along with implementing MiFID, is also aiming to move to regulation by principle detailed rules. It seems that the FSA will rely quite heavily on industry guidance when assessing the adequacy of standards.

## BEST PRACTICE

The MFA and AIMA have both produced lengthy best practice guidance notes. Whilst they cover a wide range of relevant issues, compliance with them is voluntary. This body of work has been added to by the Hedge Fund Working Group which includes senior figures from the European hedge fund industry. Their work is currently out for consultation and, again, looks to establish a voluntary code of best practice standards. Given the FSA's desired approach, the guidance notes may well take on more significance should they become endorsed in practice.

## DISTRIBUTION

The distribution regimes internationally are equally inconsistent. In the UK, distribution of promotional literature is restricted to certain categories of investor, based on sophistication and wealth. In the US, the number and financial strength of those who can actually invest in funds is prescribed. Throughout Europe, the distribution requirements vary. The local distribution nuances in Hong Kong, Singapore and Australia are equally individualistic and others that are becoming increasingly

relevant, China and India, show little indication of simplifying the situation. Firms who promote their products internationally need to ensure they have regard to the requirements of the territories they promote from and into.

## THE FUTURE

Currently, ensuring survival following the credit crunch is preoccupying senior management. However, as the outlook stabilises regulatory attention in Europe will turn to the effectiveness of the arrangements that firms have adopted to implement MiFID. Many will have completed risk assessments and these will become subject to disclosure under Pillar 3 of ICAAP during 2008. Firms and investors will be able to compare the rigour of their approach with that of their peers.

Monitoring of best execution will be a new challenge for many European firms not already subject to SEC requirements. Even then, the evidential standards and weight given to the relevant individual components will need to be reviewed. For the first time also, the suitability of investment decisions made on behalf of funds will be scrutinised. Firms implementing several strategies are likely to face systems and controls challenges that require holistic and quantitative risk management solutions.



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