Hedge Funds Oversight

Consultation Report

OICU-IOSCO

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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This paper is for public consultation purposes only. It has not been approved for any other purpose by the IOSCO Technical Committee or any of its members.

Foreword

The IOSCO Technical Committee has published for public comment this consultation report on Hedge Funds Oversight. The Report makes preliminary recommendations of regulatory approaches that may be used to mitigate the regulatory risks posed by hedge funds.

The Report will be finalised after consideration of comments received from the public.

How to Submit Comments

Comments may be submitted by one of the three following methods **on or before 30 April 2009.** To help us process and review your comments more efficiently, please use only one method.

1. E-mail

- Send comments to Greg Tanzer, Secretary General, IOSCO at the following email address: FinancialEntities@iosco.org
- **The subject line of your message should indicate "Public Comment on the Hedge Funds Oversight: Consultation Report".**
- Please do not submit any attachments as HTML, GIF, TIFF, PIF or EXE files.

OR

2. Facsimile Transmission

Send a fax for the attention of Greg Tanzer using the following fax number:
+ 34 (91) 555 93 68.

OR

3. Post

Send your comment letter to:

Greg Tanzer
Secretary General
IOSCO

C / Oquendo 12
28006 Madrid
Spain

Your comment letter should indicate prominently that it is a "Public Comment on the Hedge Funds Oversight: Consultation Report"

Important: All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

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BACKGROUND

1. The Task Force on Unregulated Financial Entities ("the Task Force"), co-chaired by the CONSOB of Italy and the FSA of the United Kingdom, was established by the IOSCO Technical Committee on November 24, 2008[1] in order to support the initiatives undertaken by the G-20 to restore global growth and achieve needed reforms in the world's financial systems following the recent financial crisis.

2. The Task Force was requested to examine issues surrounding unregulated financial entities. Given the G-20 particular interest in hedge funds, the Task Force decided to focus its work on hedge funds[2], rather than deal with other potentially 'unregulated' entities such as private equity funds (which have very recently been reviewed by IOSCO[3]) or Special Investment Vehicles (which could as easily be described as 'products' rather than 'entities'). It is noted however that many of the observations and conclusions described in this report may be applicable to other market participant entities that hold and/or control large pools of capital. The Task Force was mandated to present its interim report ("Report") at the Technical Committee meeting in February 2009 and this will be input into the next G-20 summit in April 2009.

3. The G-20 Action Plan states: "Private sector bodies that have already developed best practices for private pools of capital and/or hedge funds should bring forward proposals for a set of unified best practices. Finance Ministers should assess the adequacy of these proposals, drawing upon the analysis of regulators, the expanded FSF, and other relevant bodies."[4] Chapter 2 and Annex 4 outline the key best practices that have been developed at this time. Although unified global best practices have yet to be developed, IOSCO, in collaboration with a number of private sector groups, created a hedge fund matrix, which is a first step towards harmonisation of existing hedge fund industry sound practices to all stakeholders.[5]

4. The Task Force undertook to develop recommended regulatory approaches to mitigate risks associated with the trading and traditional lack of transparency of hedge funds. This Report presents preliminary recommendations in Chapter 3.

5. The recent financial crisis has uncovered a series of vulnerabilities in the international

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1 http://www.iosco.org/news/pdf/IOSCONEWS134.pdf.

2 In some recent documents, international groupings such as the G-20 and the G-30 have used the term of "private fund" and/or "private pools of capital" for the purposes of this Report we treat such terms as referring to hedge funds. It should also be noted that hedge funds are not actually 'unregulated' in the strict sense of the word in many jurisdictions – as often the hedge fund managers are subject to registration/authorisation and on-going supervision/monitoring.

3 *Private Equity* - Final Report, Report of the Technical Committee of IOSCO, May 2008, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD274.pdf.

4 *Declaration Summit on Financial Markets and the World Economy, Action Plan to Implement Principles of Reform*, G-20, 15 November 2008, available at http://www.g20.org/Documents/g20_summit_declaration.pdf.

5 The hedge fund matrix provides the user with the means to compare the core principles throughout the various guides as well as to drill down to the guidance for each. It is available at www.hedgefundmatrix.com.

financial system. The market events of the last year illustrate that investment risk can spread across global economies, asset classes and capital structures. Financial institutions and individuals have been exposed to the systemic risks associated with the broken trust and loss of confidence in the capital markets. The spreading lack of investor confidence has also had an adverse impact on investment funds. Frozen credit markets combined with recent large scale frauds have weakened existing and potential investor confidence in every category of investment fund and have made investors suspicious of non-transparent investment activity by large capital pools. Recommendations dealing with such entities were introduced in the report recently issued by the G-30.[6]

6. For investor confidence to return to these funds action may be necessary with the realization that global economies are interconnected and financial instruments and investment vehicles interdependent, restoring investor confidence will require the application of common approaches to regulatory risks across multiple jurisdictions and different financial instruments.

SCOPE

7. The purpose of this Report is to describe the operating environment of hedge funds, highlight the associated regulatory risks (Chapter 1), review and illustrate the work and recommendations issued by IOSCO and other international organizations and regulators in this area (Chapter 2) and make preliminary recommendations of possible principles and actions that may serve to mitigate these risks (Chapter 3).

8. Although there is no consistent or agreed definition of the term hedge fund, previous IOSCO works recognised that an approach for identifying these types of entities is to look at the kinds of characteristics of and strategies employed by institutions that would consider themselves to be hedge funds. On this basis, IOSCO has considered as “hedge funds” all those investment schemes displaying a combination of some of the following characteristics:

- borrowing and leverage restrictions, which are typically included in collective investment schemes related regulation, are not applied, and many (but not all) hedge funds use high levels of leverage;
- significant performance fees (often in the form of a percentage of profits) are paid to the manager in addition to an annual management fee;
- investors are typically permitted to redeem their interests periodically, e.g., quarterly, semi-annually or annually;

6 *Financial Reform, A Framework for Financial Stability*, Group 30, January 15 2009, available at www.group30.org/pubs/recommendations.pdf. The recommendations include: (1) managers of highly leveraged and larger unregulated entities should be required to register with a regulator; (2) regulators should have authority to require periodic reports and public disclosures of appropriate information; (3) for systemically significant unregulated entities the regulator should establish appropriate standards for capital, liquidity, and risk management; and (4) the appropriate regulator should be based on the primary business location of the manager.

- often significant 'own' funds are invested by the manager[7];

- derivatives are used, often for speculative purposes, and there is an ability to short sell securities;

- more diverse risks or complex underlying products are involved[8].

9. The Task Force acknowledges that, despite the broad characteristics described above, it is difficult to define hedge funds on a universal basis, given their different legal and business structures – not only across different jurisdictions but even within a single jurisdiction.

10. There is no single market strategy or approach pursued by hedge funds as a group. Rather, hedge funds exhibit a wide variety of investment styles, some of which use highly quantitative techniques while others employ more subjective factors. Researchers and other industry observers therefore often classify hedge funds according to the main investment strategy practiced by the funds' management. Global-macro funds, for instance, take positions based on their forecasts of global macroeconomic developments, while event-driven funds invest in specific securities related to such events as bankruptcies, reorganizations, and mergers. A relatively small set of market-neutral hedge funds employ relative-value strategies seeking to profit by taking offsetting positions in two assets whose price relationships are expected to move in a direction favourable to these offsetting positions.

11. Hedge funds are also diverse in their use of different types of financial instruments. Many hedge funds trade equity or fixed income securities, taking either long or short positions, or sometimes both simultaneously. A large number of funds also use exchange-traded futures contracts or over-the-counter derivatives, to hedge their portfolios, to exploit market inefficiencies, or to take outright positions. Still others are active participants in foreign exchange markets. In general, hedge funds are more active users of derivatives and of short positions than are mutual funds or many other classes of asset managers.[9] In this respect, the trading activities of hedge funds are similar to those undertaken by the proprietary trading areas of large commercial and investment banks.

12. In order for hedge funds to conduct their active trading and to employ leverage, it is necessary for them to enter into business relationships with other entities. Hedge funds

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7 We use the terms "hedge fund manager" and "manager" to refer to the entity that establishes the investment profile and strategies for the hedge fund and makes the investment decisions on its behalf.

8 See the definition of hedge funds in *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds* — Final Report, Report of the Technical Committee of IOSCO, February 2003, p.4, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD142.pdf, and *The Regulatory Environment For Hedge Funds, A Survey And Comparison* — Final Report, Report of the Technical Committee of IOSCO, November 2006, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD226.pdf .

9 Hedge funds are only one example of a collection of institutions that actively trade securities and derivative instruments. Among the wide range of institutions participating in this trading activity are hedge funds, trading desks of banks, securities firms and insurance companies, open-end funds, and other managed funds. Some of these institutions engage in trading activity more intensively than others.

typically use banks and prime brokers as counterparties.[10] Counterparty relationships can lead to credit exposures.

13. Credit exposures between hedge funds and their counterparties arise primarily from trading and lending relationships, such as through derivatives and repurchase agreement ("repo") transactions. These exposures, which are often reciprocal, are created when changes in market prices cause the replacement values of transactions to rise above their value at inception. Thus, a default of either the hedge fund or the counterparty would cause a loss to the other party because the transactions can only be replaced at the market prices prevailing after default.

14. In addition to the credit exposures stemming from trading relationships, further credit exposure may be realized by counterparties when they extend credit to hedge funds through credit lines. Hedge funds can face considerable liquidity risk through mismatched cash flows of assets and liabilities. Revolving lines of credit and broker loans are sometimes used to bridge these mismatches. However, these credit lines often entail high costs, and thus may not be used for establishing leverage. Hedge funds generally can achieve economic leverage in their positions more cheaply in other ways, such as through repo and derivatives transactions.[11]

15. Counterparties seek to manage these exposures through a variety of safeguards including due diligence, disclosure, collateral practices, credit limits, and monitoring. For example, banks and securities firms typically impose on-going financial reporting requirements on their hedge fund customers as part of their credit-risk assessment and risk-management process. The variability of a hedge fund's financial position and risk profile, however, makes traditional tools of financial statement analysis less effective in assessing the credit exposure to a hedge fund. Because of the difficulties of assessing the creditworthiness of hedge funds, counterparties typically use collateral as a risk mitigation device.[12] Credit limits on counterparty exposures are an important credit-risk management tool that serve to control credit-risk exposures through diversification.[13]

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[10] Prime brokers are broker-dealers that clear and finance customer trades executed by one or more other broker-dealers, known as executing brokers. A prime broker in the U.S. acts as a custodian for the customer's securities transactions and funds. Prime brokers also act as clearing facilities and accountants for all of a customer's securities transactions wherever executed. Specifically, prime brokerage generally includes the following: providing intraday credit to facilitate foreign exchange payments and securities transactions; providing margin credit to finance purchases of equity securities; and borrowing securities from investment fund managers on behalf of hedge funds to support the hedge funds' short positions (thus allowing investment funds to avoid direct exposure to hedge funds). A prime broker for a hedge fund would, therefore, be expected to have greater knowledge as to the credit exposure posed by that hedge fund than would any executing broker.

[11] See *Hedge Funds, Leverage and the Lessons of Long Term Capital Management*, Report of the President's Working Group on Financial Markets, April 1999, available at www.ustreas.gov/press/releases/reports/hedgfund.pdf.

[12] While collateral can mitigate credit risk in trading relationships, it does not eliminate it. For example, the liquidity support provided to a hedge fund may be withdrawn during periods of stress when it is most needed. This vulnerability of the fund, in turn, can affect other hedge fund counterparties, especially those that use collateral to control credit risk.

[13] Like other sources of credit risk for banks and securities firms, credit exposures to hedge funds arising from both trading activities and direct lending are subject to credit limits. Credit limits may take the form of an overall limit across all product and business lines, and sub-limits may be applied at the level of individual products. Limits may also be applied at the industry level — for instance, to hedge funds

16. Traditionally, hedge fund investors have been institutional or other sophisticated investors which have led regulators in certain jurisdictions to exempt these funds from supervisory requirements such as registration, disclosure requirements and risk management. In other jurisdictions however hedge funds or hedge fund managers are subject to a certain amount of regulatory oversight.

as a group.

CHAPTER 1 OVERVIEW OF RISKS POSED BY HEDGE FUNDS TO CAPITAL MARKETS – LESSONS DRAWN FROM THE FINANCIAL CRISIS

Introduction

17. Chapter 1 outlines the potential risks posed by hedge funds and their managers to the financial markets under ordinary market conditions and where markets may be suffering from stress or instability.

18. Securities regulators view potential risks through the spectrum of their regulatory objectives to maintain market confidence and to protect investors. Hedge funds can pose risks to these objectives under normal circumstances. These risks are magnified when financial markets are suffering from stress or instability and new risks are uncovered. So, for many regulators, the current financial crisis has highlighted the need to have robust regimes to ensure that the inherent risks that hedge funds pose do not affect market confidence and investor protection. In particular, due to the cross border effects of hedge funds and the nature of their activities, they can pose systemic risks. The Task Force believes that global regulatory response is required to appropriately and effectively mitigate the inherent risks, including systemic risk, along with stronger cooperation and information sharing arrangements between regulators. Although this Report attempts to set broad parameters for collective action, many details will need to reflect local circumstances, laws, markets, etc.

19. While this Chapter of the Report describes the risks posed by hedge funds, it is important to recall that hedge funds may provide benefits to financial markets. In the financial marketplace, hedge funds provide liquidity, price efficiency, and risk distribution, and contribute to the further global integration of markets. Because of the varying strategies employed by hedge funds, they are often the willing buyers or sellers that provide additional liquidity to financial markets. Hedge funds contribute even more significantly to marketplace liquidity in less traditional markets. Many hedge funds seek to create returns by targeting price inefficiencies, including wide bid/ask spreads. While this activity certainly benefits the hedge funds that are profiting from the trades, it has the salutary effect of creating narrower spreads and more efficient markets. Hedge funds can help mitigate market-wide concentrations of risk by transferring and distributing market risk through their willingness to be counterparties in derivatives trades.[14]

20. Hedge funds can have a direct positive impact on the investing community. Speaking broadly, hedge funds can provide investors with opportunities for diversification,

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[14] See, for example, *Implications of the Growth of Hedge Funds*, Staff Report to the United States Securities and Exchange Commission, September 2003, available at www.sec.gov/news/studies/hedgefunds0903.pdf; *Best Practices for the Hedge Fund Industry*, Report of the Asset Manager's Committee to the President's Working Group on Financial Markets, January. 2009, available at: http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf; and *Hedge Funds and the Financial Market*: Hearing Before the House Committee on Oversight and Government Reform, November 2008 (testimony of participants), available at: http://oversight.house.gov/story.asp?ID=2271.

"alpha" or excess returns, and capital protection in down markets. In contrast to conventional investment vehicles employing traditional "go-long" strategies, the flexibility in the hedge fund structure enables strategies that attempt to produce positive returns in both bull and bear markets; that is, providing opportunities for generating "alpha" or excess returns, even in thriving years, and attempting to provide capital protection (or better) in declining markets. It is worth noting that as the hedge fund industry grows and becomes more mature and institutionalized, excess returns have become harder to find.

21. There has been a significant body of work over the last decade to assess the risks hedge funds pose to the financial markets. This work has lead to a number of different domestic regulatory regimes with regard to hedge funds and their managers. In addition, a number of voluntary codes have been proposed which have responded to areas of concern (further details are available in Chapter 2 of this Report).

22. The following section outlines a number of risks hedge funds may pose to the financial markets; these are split into inherent risks and risks that have been highlighted by recent market events. Many of these risks are interrelated and act to reinforce each other. Moreover, the inherent risks increase when markets suffer from stress or instability. For each potential risk the section aims to provide an outline of:

- current market practice;
- mitigating factors; and
- the risks to the market.

Inherent risks

23. The inherent risks relating to the activities of hedge funds and their managers are primarily a result of two factors:

    a. Lack of transparency regarding the funds to investors and other market participants such as counterparties and regulators.

    b. Conflicts of interest between fund managers and other market participants, particularly regarding manager remuneration.

24. These risks can be amplified by poor systems and controls. Indeed, in many cases where issues have been found regarding the activities of hedge funds or their managers there have also been problems with the control environment.

<u>Transparency, reporting and disclosure risks</u>

25. Some aspects of hedge fund activity are by their nature opaque. For instance, hedge funds often make widespread use of new instruments which are traded over-the-counter rather than on-exchange or on centralised trading systems, and for which there is little market transparency. In addition, many hedge fund managers consider that their investment strategies are proprietary and public knowledge of their positions would be detrimental to their returns.

26. As with all funds if a lack of transparency is combined with poor systems and controls it can amplify the risk of market abuse and fraud. In addition, it can make counterparty risk more difficult to assess and thus increase the risk of funds impacting more widely on the financial system. Moreover, opacity can lead to market instability as it creates significant potential for ill-informed investment decisions and can be a detriment to market confidence.

27. Many managers both manage hedge funds and raise capital for them and in certain cases, administer, value and safeguard the assets. This lack of role separation combined with a lack of transparency may lead to less substantive due diligence and investor protection than for regulated asset management funds. Currently it is argued that as hedge fund investors are relatively sophisticated or are institutional investors, they can ask for the appropriate information and protection. However, it may be questionable whether this holds true in all cases, given the asymmetry of information and power between investor and hedge fund.

Current market practice

28. In general there are good commercial reasons to provide information to investors, direct creditors and counterparties such as the desirability of maximising sales and the need to do business. However, some aspects of investor information may be not as transparent as it could be. In particular, disclosure of valuation procedures, the existence of any 'side letters'[15] and 'gating structures',[16] may not happen consistently. Similarly, disclosure to investors where systems and controls have been audited by an independent outside party, or more generally disclosure of the risk policy of the fund they have invested in may also be inconsistent. A recent IOSCO consultation report regarding funds of hedge funds[17] and work by the President's Working Group[18] outlines many areas where investors may lack clear and appropriate information.

29. There appears to be little incentive for hedge funds or hedge fund managers to provide information, such as their asset allocations, to regulatory bodies or to the market in general,. In addition, there is the question of whether a point in time asset allocation could give an accurate underlying position of a dynamic fund.

Mitigating factors

30. Hedge funds typically raise funds from institutional investors such as funds of hedge funds and financially sophisticated individuals. This sophistication should imply that

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15 Hedge funds can give preferential treatment to certain categories of (usually large) investors. This preferential treatment may be set forth in "side letters". Other investors in the fund may not have knowledge of such preferential treatment.

16 Gating structures limit an investors ability to reduce their investment either by putting time limits on what can be realised or only allowing investors to liquidate a percentage of their holdings in any one period.

17 *Proposed Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices* — Consultation Report, Report of the Technical Committee of IOSCO, October 2008, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD281.pdf.

18 *Principles and Best Practices for Hedge Fund Investors*, Report of the Investors' Committee to the President's Working Group on Financial Markets, 15 January 2009, available at http://www.amaicmte.org/Public/Investo rs%20Report%20-%20Final.pdf.

they are more able and likely to perform appropriate due diligence on a hedge fund before investing. Indeed the important documents for hedge fund due diligence have recently been highlighted by both the Presidents Working Group and IOSCO.

31. There are some general requirements on all market participants that apply as well to hedge funds, for instance those requirements applying to the disclosure of major shareholdings, or transparency of trading of certain financial instruments. Furthermore, some jurisdictions have significant regulatory information requirements. However, some jurisdictions require little or no disclosure from hedge funds and associated counterparties such as prime brokers, with others requiring regular reporting of certain information. For example, in the United States, the SEC, in regular meetings with prime brokers receives information on broker exposure to hedge funds as well as other risk information, while the CFTC requires all market participants meeting certain criteria, including hedge funds, to provide end-of-day position data to the agency regarding positions on futures exchanges subject to CFTC oversight. In the Euro zone information on the asset under management is collected pursuant to Regulation no. 958/2007 of the European Central Bank[19] which includes hedge funds in so far as they are registered by a EU national regulator. In addition, there are a number of industry codes of conduct regarding transparency which are outlined in Chapter 2. While these codes are not enforceable they do provide investors and others with an example of best practice by which to judge the transparency of all hedge funds.

The risks to the market

32. The main risks to the financial markets resulting from the lack of transparency, as highlighted in paragraph 26, are the possible amplification of the risk of market abuse and fraud, the added difficulty in assessing counterparty risk, and market instability. There is no widespread commonality from jurisdiction to jurisdiction regarding information to investors and counterparties. Generally speaking, some investors are comfortable with the provision of information by hedge fund managers. However given the number of information deficiencies highlighted in paragraphs 28-29 it may be debatable as to whether the information is sufficient. It appears that the information provided to counterparties (i.e. banks and prime brokers) providing leverage to the hedge fund sector is greater than that given to investors. Despite the focus on additional risk controls and information provision of funds to their prime broker counterparties, following the Long Term Capital Management ("LTCM") crisis, it is not clear that information is yet as extensive as some counterparties would like. One could contend that if the provision of information to these parties is not adequate, the counterparties are not acting in accordance with the best interest of their firm even allowing for turnover fees.

33. The provision of information to the market in general could be described as inconsistent or even opaque and the provision of information to regulators varies. It is unlikely that any one jurisdiction has a blueprint for others to follow. Specific attention should be focused on: what additional information should be provided by hedge funds/hedge fund managers and associated counterparties and with what frequency, in order to enable regulatory bodies (and other market participants) to more accurately measure the risks

19 www.ecb.int/ecb/legal/pdf/l_21120070811en00080029.pdf.

being run by these parties.

34. Transparency is not an end in itself, it is a regulatory tool designed to address objectives such as market integrity, consumer protection and financial stability. So it is important to agree what (if any) information should be made available by hedge fund managers, in addition to what they choose to provide, to (i) investors, (ii) creditors and counterparties, (iii) the general public, and (iv) regulators. It is equally important to establish why that information should be provided, what this achieves and what if any issues would follow from the provision of additional information. For example, there is the possibility of moral hazard if regulators were to receive information, which may undermine the potential benefit of obtaining it, particularly if investors relied on government review, and regulatory inaction was regarded by the market as approval. In any event, because of the lack of international agreement on information and data sharing, regulators may have only partial data on which to base informed decisions about risk and consequently proportionate regulatory action to mitigate that risk. However, given the lack of transparency inherent in current hedge fund business models, issues like investor risk, systemic financial risk and market abuses may be better addressed with some regulatory intervention in terms of assuring quality information and disclosure.

Compensation risks

35. As with all funds, performance based incentive structures combined with insufficient control procedures and fund opacity, may generate an increased likelihood that fund managers seek to benefit at the expense of investors or take on more risk than outlined in their prospectus.

36. Because hedge fund managers typically receive a significant uplift in compensation if the performance of the fund is sufficient (see paragraph 38), there might be a greater incentive for inappropriate practice. In particular, compensation structures may create a number of additional risks, such as the incentive to over-inflate valuations and/or increase risk profiles beyond desirable limits. Hedge fund fee structures may also encourage management firms that offer traditional mutual funds and hedge funds to inappropriately favour hedge funds when placing or allocating deals.

37. This conflict of interest could lead to market instability as investors are badly informed and managers take riskier positions to increase potential returns – for example managers may be incentivised to have higher leverage to capital ratios than optimal for the fund as this could increase the likelihood for them to make their performance fees (see paragraph 50).

Current market practice

38. The hedge fund fee structure typically includes both a management fee and a performance fee for the manager. The manager typically receives a management fee (1-2% of net assets) and a performance fee (annual or quarterly), which is a percentage (usually 20%) of the fund's net capital appreciation (or, in the case of losses, the so called "high-water marks" may apply). This performance fee makes managing a hedge fund potentially more lucrative than a mutual fund. Both the management fee and the performance fee can be motivating factors behind possible questionable activity as hedge fund managers seek to report an increase in both assets under management and performance in order to increase fees or close funds to avoid periods of sustained losses.

39. Moreover, some hedge fund managers may have insufficiently developed control mechanisms and insufficient incentive to develop them. This is exacerbated by the fact that the vast majority of hedge fund managers are small and so control structures are subject to particular size and resource constraints.

Mitigating factors

40. Good risk management, governance and control can mitigate many of the risks described above. As with many of these risks, improvements in valuation techniques and accuracy, and transparency about valuation policies, can also be considered as an issue across the market as a whole, not just in the context of hedge funds. Furthermore, a tighter control environment within hedge fund managers is likely to benefit valuation policies as well as risk and conflicts management as further explained in the IOSCO report *Principles for the Valuation of Hedge Fund Portfolios*.[20]

41. Investment in their own funds by managers may also help to mitigate some of the conflicts of interest in relation to investors as it can align the interest of the manager with the investor. On the other hand, this arrangement may also induce some managers to take on greater amounts of risk and display particularly risky short-term strategies.

The risks to the market

42. The main risks to the financial markets resulting from the conflict of interest and compensation structures is the incentive for managers to increase their returns and in particular to hit high-water targets. As described above this may result in greater than optimal levels of leverage, taking exceptionally risky positions, a heavy focus on short term profits and incentives to wind down funds and re-open funds. The result of non-optimal risk taking is a reduction in financial stability and a worse deal for investors. Moreover, at the extreme managers could act either fraudulently or by abusing the market. It is unclear whether hedge funds are necessarily more prone to fraud or focusing more on the short-term than other market participants.[21]

43. Performance incentives were intended to align manager and investor interests but can also generate potential conflicts. There is a regulatory concern that performance based incentive structures combined with the opacity of some aspects of hedge fund behaviour may combine to generate a regulatory concern that managers might seek to benefit at the expense of investors.[22] This issue is linked to the broader remuneration issues being

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20 *Principles for the Valuation of Hedge Fund Portfolios* — Final Report, Report of the Technical Committee of IOSCO, November 2007, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD253.pdf.

21 It can be argued that the operating environment of hedge funds, and in particular the opacity, does make market abuse of particular concern with them. Investigations of insider trading on the part of hedge funds may be more difficult because of the challenges posed by establishing that a particular individual or entity (especially a hedge fund manager) was in possession of material non-public information and in fact traded on it in breach of a fiduciary duty, and to establish those facts based on admissible evidence.

22 Some potentially serious issues could be:

- circumventing control procedures;
- manipulating a fund's trading activity to achieve "artificial" results;
- issuing false valuations;
- theft of funds/securities (where the manager has control over investor assets);

considered actively by the Financial Stability Forum (FSF).

44. With regard to trading behaviour, some hedge fund activity may be more likely to test the boundaries of acceptable market practice with regard to insider trading and market manipulation, because of fund managers close relationships with counterparties and knowledge of the market. On the other hand, as mentioned above, this concern is not unique to hedge funds and, given the replication of strategies similar to those of hedge funds among banks and other market participants, questions of the effectiveness of market abuse regimes should be addressed more widely than in a limited category of participant, and should instead be directed at the market as a whole.[23] This is particularly the case for policies which affect market performance, such as short-selling rules (see paragraphs 57-60).[24]

Do you believe that the FSF work will sufficiently cover the remuneration/ compensation issues / risks?

Risks highlighted by the recent market events

45. There are divergent views of the role hedge funds have played in the recent market events. Some commentators suggest that the extent to which hedge funds increased their exposures by leveraging up their portfolios placed additional stress on other market participants and the financial system generally leading to the amplification of the asset price bubble and reduced liquidity - some have even argued that hedge funds have been even more cyclical in their behaviour than banks. On the other hand, many argue that hedge funds reduce the likelihood and prevalence of asset bubbles in general by going short on overvalued assets: since managers want to make money by buying low and selling high, they generally act as a stabilizing influence in that they buy when prices are down and sell when prices are up, thus reducing volatility. Moreover some claim that hedge funds play an essential role in maximising the impact of available investment capital and are victims of a crisis caused by poor risk and credit management procedures at other "regulated" financial institutions. The hedge fund sector has certainly contracted significantly and continues to do so.[25]

- misleading/performance history;
- inappropriate calculation of fees and expenses;
- diverging from stated investment strategy/guidelines;
- misrepresentation of investment risk guidelines/controls;
- undisclosed firm/individual conflicts of interest with counterparties, issuers, affiliates of the adviser and other investors/clients; and
- charging the fund for services which have not been supplied.

23 See p. vi of *Hedge Funds Transparency and Conflict of Interest*, Professor Narayan Naik, *European Parliament Policy Department Economic and Scientific Policy*, *IP/A/ECON/IC/2007-24*, December 2007.

24 This is being considered by the IOSCO Task Force on Short Selling, which is looking at ways of developing a common international approach and guidance with respect to the regulation of short selling. See: http://www.iosco.org/news/pdf/IOSCONEWS134.pdf

25 From its peak in the summer of 2008, with approximately US$2 trillion worth of assets under

46. Regardless of whether they played a role in amplifying the crisis or merely have been caught in it along with other investors, there are undoubtedly areas of concern that should give rise to further consideration for policy makers and regulators. We explore some of these below.

Leverage

47. The key concern with leverage is that it may transfer instability to the financial market in general and potentially therefore to the wider economy. There appear to be two fundamental ways in which this can happen: (i) by way of increasing losses incurred by investors and lenders in the failed hedge fund; or (ii) by way of the potential disorderly pricing of markets as funds rapidly unwind positions.

48. Failures in hedge funds may have wider implications to the financial markets particularly when hedge funds are leveraged. This contagion effect focuses heavily on the way in which hedge funds leverage their investments through borrowing from banks and prime brokers. One of the repercussions of recent market falls has been the need for both lenders and borrowers alike to pay significant attention to their counterparties to ensure that lending is prudent.

49. Just as leverage increases the magnitude of returns and losses for hedge funds, the price volatility of the instruments in which hedge funds invest will be magnified. Asset prices are likely to rise or fall more rapidly if larger investments are, respectively, made or redeemed. This has been of specific concern to a number of regulatory bodies over the latter part of 2008 and into 2009, with many jurisdictions introducing 'short-selling' restrictions to prevent any potential market dislocations.

Current market practice

50. Hedge funds typically use leverage[26] as a way of magnifying potential returns (but may also magnify potential losses). Leverage should however not be looked at in isolation, as some relatively low risk trading strategies rely on the use of leverage to take advantage of small pricing discrepancies.[27] Nor are the issues of leverage solely related to hedge funds; indeed hedge funds generally have much lower levels of leverage than many regulated entities. However, where there is excessive use of leverage, and strategies that involve leverage, by hedge funds this can be problematic. And it is not unusual to see hedge fund failures linked to problems of excessive leverage. The average leverage ratio for the hedge fund industry fell from 1.7 times in 2007 to 1.4 times in 2008, though it is worth noting that the average leverage changes significantly across fund types (for example, leverage is 4 times capital for tactical/macro funds; 5 to 9 times capital for convertible arbitrage funds; and as much as 10 times capital for

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management, it is estimated that the value of assets under management, of hedge funds will open in 2009 at around US$1 trillion.

26 In this context "leverage" is defined to mean borrowings from banks and prime brokers as opposed to embedded leverage within the instruments they invest in.

27 Though it is worth noting that LTCM had just took such a strategy and was reported to have a leverage to capital ratio of 25 to 1. See p. 12 of the *Hedge Funds, Leverage, and the Lessons of Long Term Capital Management*, President's Working Group on Financial Markets, 1999, available at www.ustreas.gov/press/releases/reports/hedgfund.pdf.

relative value/fixed-income arbitrage funds).[28]

51. Leverage is provided to hedge funds by banks and prime brokers on a collateralised basis. It is done to facilitate the investment strategies of hedge fund managers and, like any lending, should be done prudently and within the risk appetite of both lender and borrower. In addition, leverage or "embedded leverage" can be created through structured products or derivatives contracts. Derivatives can be a source of funds, but simultaneously create obligations, which upon failure might contribute to systemic risk.

52. The main mechanism through which disruptions or failures in hedge funds may transmit themselves to the wider market and hence increase systemic risk is through the banks/prime brokers, who are their creditors and may also offer them trading facilities. These banks then transmit the instability to the rest of the banking sector through which, by virtue of its provision of credit, payment and clearing services, they impact directly on the real economy.

Mitigating factors

53. Whilst there is a risk that lending to hedge funds will not be repaid, thereby causing losses to banks/prime brokers, this does not appear to have been prevalent in the recent financial crisis. Although losses have undoubtedly occurred, these tend to relate either to the investment risk of the hedge fund or counterparty exposures created outside of lending arrangements. Indeed in some cases (e.g., Lehman) it was actually hedge funds who were hit by exposure to their prime brokers.

54. Strong risk management, and sufficient capital requirements, particularly at the banks/prime brokers, is an important mitigating factor to the potential risk of contagion from hedge funds to the wider market and economy. However, given the questions regarding the adequacy of the information provided to hedge fund counterparties (see Paragraphs 28-34 above) it is questionable as to whether they are always asking for and therefore always getting the right information.

The risks to the market

55. Hedge fund management requires the capability for particularly robust risk management both by the manager and by the investment banks who need to be able to assess the combined risks of their own operations, prime brokerage and investment relationships with hedge funds. It is arguable whether the appropriate standards apply universally across the market or that investment banks and prime brokers can fully assess the risks given the issues regarding fund transparency.

56. Prior to the financial crisis, hedge fund assets under management were growing at a significant rate and there was a strong incentive for banks to lend money to this increasingly important area. This may well have led to imprudent lending practices or preferential treatment such as reduced margins, but it appears that those banks who lent on a prudent basis and/or had robust collateral arrangements in place have not suffered as a result.

[28] See p. 41 of *Global Financial Stability Report*, Report of International Monetary Fund, October 2008, available at http://www.imf.org/external/pubs/ft/gfsr/2008/02/pdf/text.pdf.

Market behaviour and trading/investment strategy risks

Current market practice

57. Though hedge funds can help market stability by increasing liquidity and enhancing price discovery, the failure or significant distress of a large fund or group of funds could cause serious market disruption, including impairment of price discovery, trade execution and settlement malfunction, and other deleterious effects on market quality. Outlining each of the above:

    i. Price discovery would be impacted if a significant provider of liquidity to markets is no longer willing or able to participate. The reduced number of participants will lead to larger bid-offer spreads.

    ii. Trade execution becomes harder if there is an asymmetry in the market due to concentration of positions combined with a forced unwinding.

    iii. Settlement stresses would be introduced through the unwinding of complex structures.

58. Hedge funds can have a significant influence on markets due to the scale of their trading and on the individual companies into which they invest. Some hedge fund strategies involve making concentrated investments in complex and often illiquid financial instruments and in particular market segments (usually on a leveraged basis designed to amplify returns). In certain market circumstances this can produce correlated trading, which again exacerbates volatility[29] for example short selling. Coupled with the increasing sensitivity of hedge fund investors to performance, this can lead to significant liquidity imbalances at times of large outflows, leading to forced asset disposals and disorderly markets in those assets. Moreover, in some jurisdictions there has been concern that hedge fund managers may also have had an undue influence on individual companies. However, as with many of the issues raised in this Chapter the question of undue influence is not solely an issue for hedge funds, but applies to a range of activist shareholders. Furthermore, academic studies, on the whole, have not shown this to be the case.[30]

59. In turbulent market conditions it is natural that banks and prime brokers make more

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29 See discussion on market dislocation in July-August 2007 on p. 79, *Challenges in Quantitative Equity* Management, Fobozzi, Focardi, Jonas, CFA Institute 2008, available at http://www.cfapubs.org/doi/pdf/10.2470/rf.v2008.n2.

30 See, for example, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, Brav, Alon, Jiang, Wei, Thomas, Randall S. and Partnoy, Frank, November 2006, ECGI - Finance Working Paper No. 139/2006; Vanderbilt Law and Economics Research Paper No. 07-28, available at http://ssrn.com/abstract=948907. In here it is said that "Using a large hand-collected dataset of hedge fund activism in the U.S. over the period 2001 through 2006 we find that activist hedge funds propose an array of strategic, operational, and financial remedies and attain success or partial success in two thirds of the cases. Hedge funds seldom seek control of target companies and most of their tactics are non-confrontational. The market reacts favorably to hedge fund activism, as the abnormal return upon announcement of potential activism is in the range of seven percent, with no return reversal during the subsequent year. We show that this positive market reaction does not reflect anticipated wealth transfers from creditors to shareholders, nor does it merely reflect the information effect of stock picking by hedge funds. Target firms experience increase in payout, operating performance, and higher CEO turnover after activism."

stringent collateral requirements on hedge fund managers. In these same market conditions a fund or funds in distress being forced to unwind positions could lead to a spiral of self-reinforcing movements for other correlated funds, their banks and prime brokers, and the wider market. This tendency may be exacerbated by an increase in investor redemptions, consistent with a 'flight to quality'. Such a disorderly contraction of segments of the market may well have wider ramifications.

Mitigating factors

60. During the recent financial crisis, some counterparties have actively reduced their exposure to hedge funds, by raising margins, increasing discounts or haircuts applied to the market value of collateral and/or redeeming investments made in hedge funds.

61. In addition, when the influence of any fund is considered excessive or paramount to market abuse regulators can, and do, limit trading. While not directed specifically at hedge funds, one extraordinary example of this is the ban on short selling in 2008 in many jurisdictions.

The risks to the market

62. All funds can have a significant influence on markets and the companies in which they trade. Hedge funds add liquidity to the market but may also amplify market swings if they are forced to reduce leverage when the market declines (see paragraphs 49-51 above). So whether the overall effect of hedge fund investing has been to increase or decrease market volatility is debatable.

63. Given the countervailing impact of their actions, the risks posed to financial markets from hedge fund's trading strategies and market behaviour is difficult to assess. However, the Task Force considers that the potential risks outlined above may not at present be adequately mitigated by the current regulatory system.

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

CHAPTER 2 OVERVIEW OF THE CURRENT LEVEL OF REGULATION OF HEDGE FUNDS

64. As discussed in Chapter 1, securities regulators view potential risks from the point of view of their regulatory objectives to maintain market confidence and to protect investors. Hedge funds can pose risks to these objectives and for many regulators, the current financial crisis has highlighted the need to have robust regimes to ensure that the risks that hedge funds pose do not affect their objectives.

65. Chapter 2 reviews and illustrates the work and recommendations issued by IOSCO, other international organizations and regulators to mitigate the risks hedge funds pose to market confidence and investor protection. The Chapter outlines the work of a number of organisations including: the FSF; IOSCO; and industry codes. It also provides an overview of current regulation and trends in international and national regulation.

Current degree of hedge funds regulation available at international level

Indirect vs. direct regulation

66. The international regulatory community saw itself confronted with the risks presented by the operation of highly leveraged institutions (HLIs), a definition which includes hedge funds, following the Asian crisis and the collapse of LTCM. Even though the dimension of the crisis with which the industry and the regulators were confronted with was different in terms of origin, dimension and consequences from the one they are presently dealing with, it is worth examining such recommendations and regulatory approaches before drawing conclusions on possible new recommendations following the discussion in Chapter 1. Table A, under Annex 1, provides a summary of those international recommendations and regulatory approaches.

67. In 2000 the FSF, taking into account the work done at sectoral level by IOSCO and the Basel Committee on Banking Supervision (Basel Committee), as well as by industry groupings, adopted a series of high level recommendations focused on systemic risks and market dynamics concerns raised by highly leveraged institutions.

68. The FSF did not recommend applying a system of direct regulation to HLIs[31]. This was due to the belief that investors in HLIs are generally high net worth individuals or institutional investors; such investors are expected to be sufficiently wealthy and sophisticated to conduct their own due diligence. Moreover, in the view of the FSF, direct regulation could have favoured a form of moral hazard inducing investors and counterparties to reduce their normal due diligence and relax their risk management standards[32]. However, the FSF recognised the possibility of establishing such a direct

[31] See particularly the statement under no. 119, p. 38 of the FSF *Report of the Working Group on Highly Leveraged Institutions*, 5 April 2000, (the 2000 FSAF report), available at http://www.fsforum.org/publications/r_0004a.pdf?noframes=1.

[32] See no. 117, p. 37 of the 2000 FSF Report.

regulatory regime cannot be definitively rejected.[33]

69. Therefore the FSF decided to address its recommendations: (i) to already regulated financial intermediaries acting as hedge fund counterparties and credit providers, and (ii) to the hedge funds in order for them to issue a set of sound practice improving current market standards.[34] In its 2007 report,[35] the FSF stressed the need of an enhanced external oversight by regulators, however - consistently with the endorsed indirect regulatory approach - the focus was on already supervised financial intermediaries with significant HLIs business[36].

70. The FSF recognised that indirect supervision needs to be leveraged by several forms of transparency in order to yield more market discipline.[37] It did not however recommend reporting requirements on otherwise unregulated firms, because supervisors may not have the same level of resources available to all financial market participants and regulatory "moral hazard" could be increased[38].

71. The indirect approach to hedge funds' regulation was also in line with IOSCO recommendations contained in the 1999 report[39] (and taken into account by the FSF). Indeed, the 1999 IOSCO Technical Committee Report contains recommendations mostly addressed to regulated firms acting as counterparty for HLIs.

72. However, it seems that new trends towards a more direct regulatory oversight approach (addressed to the managers and the fund) are emerging in the international community. The recently issued G-30 Report[40] recommends that "*Managers of private pools of capital that employ substantial borrowed funds should be required to register with an appropriate national prudential regulator* (….). *The prudential regulator of such managers should have authority to require periodic regulatory reports and public disclosures of appropriate information regarding the size, investment style, borrowing, and performance of the funds under management*". The G-30 recommendations also deal with the "moral hazard" issue identified by the FSF in 2000 by stating that "*Since introduction of even a modest system of registration and regulation can create a false impression of lower investment risk, disclosure, and suitability standards will have to be reevaluated*". The G-30 also considers that "*For funds above a size judged to be potentially systemically significant, the prudential regulator should have authority to*

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33 See p. 36-38 of the 2000 FSF Report.

34 In particular, the 2000 FSF Report addresses the issue of risk management and disclosure in hedge funds by encouraging the industry to draft and publish a set of sound practices for their risk management and internal controls. See no. 75, 76 and 77, p. 24-25, and Section II and Section IV, p. 56 and 59 of the Synthesis of recommendations of the 2000 FSF Report.

35 Update of the FSF Report on Highly Leveraged Institutions, Report of the FSF, 19 May 2007, available at http://www.fsforum.org/publications/r_0705.pdf?noframes=1.

36 See Section III of the Synthesis of recommendations, p. 58 of the 2000 FSF Report.

37 See particularly no. 92, p. 29 of the 2000 FSF Report.

38 See no. 97, p. 30 of the 2000 FSF Report.

39 *Hedge Funds and Other Highly Leveraged Institutions* — Final Report, Report of the Technical Committee of IOSCO, November 1999, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD98.pdf.

40 Financial reform: A framework for financial stability, G-30, 2009. A list of the recommendations is available at http://www.group30.org/pubs/recommendations.pdf.

establish appropriate standards for capital, liquidity, and risk management".

FSF and IOSCO recommendations

FSF recommendations

73. As outlined above, the recommendations mostly provide for an indirect regulatory approach or indicate to industry associations guiding principles to which they should inspire through best practice standards.

74. The FSF identifies "risk management" as the key area to be addressed by financial intermediaries in their dealings with HLIs (and by the hedge fund managers through the best practice developed by the industry). For a full description of the FSF recommendations, please see Annex 2.

75. The recommendations are addressed to financial intermediaries' risk management procedure and processes, credit assessment, exposure measurement, collateral management and valuation. It is worth mentioning that the International Sectoral Standard Setters (and namely the Basel Committee and IOSCO where appropriate) have issued detailed regulatory principles on such subjects.

76. In the context of this report it appears particularly relevant to recall the recommendations addressed to financial intermediaries on credit assessment and ongoing monitoring of HLIs. In the view of the FSF the credit standards applied to HLIs should be consistent with the overall credit standards of the financial intermediary. However, before starting a relationship with an HLI, financial intermediaries should receive adequate information to inform their internal credit approval processes. This should include information on:

- aggregate financial information (covering both on and off-balance sheet positions);
- financial performance;
- details of risk management procedures and controls;
- results from (and methodology of) risk measurement tests (Value at Risk (VaR), stress tests);
- general direction and scope of trading activities, including investment strategies;
- amount of leverage;
- liquidity and funding profile (including details of major counterparty relationships);
- details of large or concentrated positions;

- details of key personnel and organisational structure (including back office structure);

- where possible, third party information such as credit registers or references from known parties should be accessed. In all cases, financial intermediaries should be confident that they are dealing with institutions of sound reputation before starting counterparty relationships;

- the legal status and investment authority of the HLI;

- the connected entities of an HLI or group of HLIs. If there are connected entities: the relative size and activities of group members; the role that the lead member plays in the group as a whole and; the nature and size of any intra-group transactions;

- the purpose and structure of the transaction should be identified and the repayment capacity analysed against several scenarios;

- procedures should be in place to ensure that the information received above is updated on a timely basis.

77. The onus of assuming the information in the FSF recommendations is on the regulated intermediary and reference is made to the fact that an entity refusing to provide information should face tougher credit conditions.

78. As highlighted above, issues such as exposure measurement, limit setting, valuation, etc. should apply also in dealings with HLIs.

79. A second set of FSF recommendations was devoted to risk management in hedge funds. It contains guidance on the areas which should be covered by standards of "sound practices" issued by the industry. In particular, reference is made to key processes necessary to address relevant risks, including precise guidelines referring to liquidity risks. It is worth mentioning the following guiding principles:

i. Organisational structure and risk control

- hedge fund managers should clearly define the investment objectives and risk parameters for each fund and the trading policies and risk limits necessary to achieve these objectives;

- adopt an organisational structure that ensures compliance and establish a risk monitoring function that operates independently of portfolio management functions, retain appropriate resource, and ensure independent reviews;

- third parties performing key business functions (such as NAV calculation) should also be subject to appropriate controls and reviews processes.

ii. Risk management

- hedge fund managers should evaluate market risk for their portfolios both in aggregate and for relevant subcomponents of a portfolio, employ appropriate liquidity measures, evaluate the stability of sources of liquidity and have a contingency liquidity plan for periods of market stress;

- hedge fund managers should monitor both accounting-based measures of leverage and measures of leverage which reflect the relationship between the riskiness of a portfolio and the capacity of the hedge fund to absorb the impact of such risk;

- managers should also recognise the interrelation between leverage and market, credit and liquidity risk factors.

iii. Disclosure to Credit providers and counterparties

- hedge fund managers should provide credit providers and trading counterparties with information that gives a view of their funds' risk and return profiles, including changes in net asset value, profit and loss volatility, changes in net capital, market risk measures, and liquidity measures.

80. Another group of FSF recommendations covers the role of the regulator in supporting sound practice and particularly facing regulatory arbitrage and avoid "erosion from competitive pressure". It is worth mentioning that the 2000 FSF report discusses the concerns induced by the practice of establishing HLIs in offshore centers calling regulators to adopt internationally agreed standards and enhanced cooperation. Regulators were also invited to carefully monitor the use of "double leverage".

81. The FSF recommendations also made reference to the area of transparency. In this respect reference was directly made to the 1999 IOSCO Technical Committee report which indicated some favour for enhanced public disclosure directly by the HLIs, while (reporting either via financial intermediaries or direct from the HLIs) could still be considered if public disclosure failed to achieve specific objectives. The report however, did not indicate exactly which type of disclosure was necessary, even if it was stated that when crises occur, firms must be prepared and able to provide regulators with all requested information in a timely way.

IOSCO recommendations

82. As indicated above the key IOSCO report providing for recommendations on hedge funds is the 1999 Technical Committee Report[41] which was taken into account by the FSF in drafting its recommendations.

83. Notwithstanding the increasing popularity of hedge funds among investors, IOSCO so far has mostly carried out surveys and facts finding on the regulatory approaches endorsed at the national level in matters of hedge funds and investor protection. Moreover, the core part of the work of IOSCO in this area focused on the slightly different phenomenon of the funds of hedge funds due to the possible implications for retail investors (an outline of the IOSCO work in this area is provided under Annex 3).

41 *Hedge Funds and Other Highly Leveraged Institutions* — Final Report, Report of the Technical Committee of IOSCO, November 1999, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD98.pdf.

In 2003, IOSCO analysed the regulatory issues arising from the investment of retail investors into hedge funds and in funds of hedge funds identifying potential regulatory responses depending on the legal framework in each jurisdiction[42]. In 2006 IOSCO summarised the results from a survey on issues relating to investors protection arising from retail investors' participation in hedge funds and funds of hedge funds. This report did not contain recommendations, but only described the main features relating to the regulatory environment applicable to hedge funds.[43].

84. Substantive work was carried out by IOSCO in 2007 on the valuation of the hedge funds portfolios, by emanating nine principles[44]. The objective of the Technical Committee report was to prevent distortion of portfolio valuations to the disadvantage of fund investors, mitigating conflict of interest and calling for an independent and transparent review of the evaluation process. In particular, the report recommended that effective controls be placed around the hedge funds valuation process to mitigate conflicts of interest, increase independence in sourcing and review of the resulting valuations, especially with respect to complex, illiquid and hard-to-value assets.[45]

85. In 2008 IOSCO issued an update of the 2003 survey[46] on funds of hedge funds and issued a consultation report on possible international regulatory standards on funds of hedge funds related issues[47]. The proposals target managers of funds of hedge funds and seek to address regulatory issues of investor protection in light of the increased involvement of retail investors in hedge funds through funds of hedge funds. In particular, the Report is aimed at developing guidelines in the areas relating to: (i) the

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42 See *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds* — Final Report, Report of the Technical Committee of IOSCO, February 2003, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD142.pdf.

43 *The Regulatory Environment For Hedge Funds, A Survey And Comparison* — Final Report, Report of the Technical Committee of IOSCO, November 2006, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD226.pdf.

44 The nine principles provide that: 1. Comprehensive, documented policies and procedures should be established for the valuation of financial instruments held or employed by a hedge fund. 2. The policies should identify the methodologies that will be used for valuing each type of financial instrument held or employed by the hedge fund. 3. The financial instruments held or employed by hedge funds should be consistently valued according to the policies and procedures.4. The policies and procedures should be reviewed periodically to seek to ensure their continued appropriateness. 5. The Governing Body should seek to ensure that an appropriately high level of independence is brought to bear in the application of the policies and procedures and whenever they are reviewed.6. The policies and procedures should seek to ensure that an appropriate level of independent review is undertaken of each individual valuation and in particular of any valuation that is influenced by the Manager. 7. The policies and procedures should describe the process for handling and documenting price overrides, including the review of price overrides by an Independent Party. 8. The Governing Body should conduct initial and periodic due diligence on third parties that are appointed to perform valuation services. 9. The arrangements in place for the valuation of the hedge fund's investment portfolio should be transparent to investors. Please see *Principles for the Valuation of Hedge Fund Portfolios* — Final Report, Report of the Technical Committee of IOSCO, November 2007, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD253.pdf.

45 *Principles for the Valuation of Hedge Funds Portfolios*, .as referred in the previous footnote.

46 *Funds of Hedge Funds* — Final Report, Report of the Technical Committee of IOSCO, June 2008, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD276.pdf.

47 *Proposed Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices* — Consultation Report, Report of the Technical Committee of IOSCO, October 2008, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD281.pdf.

methods by which funds of hedge funds' managers deal with liquidity risk; and (ii) the nature and the conditions of the due diligence process used by funds of hedge funds' managers prior to and during investment. Standing Committee 5 of the Technical Committee of IOSCO, on Investment Management, is currently in the process of analysing the responses provided to the consultation.

A short summary of the IOSCO Technical Committee work streams is provided in the tables below under annex.

<u>Industry codes</u>

86. As highlighted above, the FSF called for the issuance of best practice standards, particularly in the area of risk management of hedge funds. To date several proposals have been issued by various groupings and associations of HLIs. A list of the relevant initiative is summarised in the table B under annex 1. However, the key sets of codes/standards, currently taken into account by the FSF, appear to be those issued by the HFWG (Hedge Fund Working Group) and the Managed Funds Association (MFA) which has broadly endorsed the PWG report (President's Working Group on Financial Markets), outlined in Annex 4.

87. In particular, to counter concerns about the opacity of hedge funds, and in response to the growing size and maturity of the industry, the key issues dealt with in the relevant industry led initiatives are:

i. *Disclosure*: all of the industry initiatives emphasised that improved disclosure practices assist in making the operation of hedge funds more transparent for investors, counterparties and the government. The recommendations are designed to assist investors to make informed investment decisions; to enable investors to monitor/measure ongoing risks associated with investments; and to enable counterparties and credit providers to assess risk. The focus is on disclosure of material information, including financial information, risk information and potential conflict of interest. HFWG refers specifically to a disclosure framework which should cover commercial terms, fees and factors which could impact performance.

ii. *Asset valuation*: valuation issues are key as a consequence of the current credit crisis, which has highlighted flaws in some models of valuation for illiquid assets. The industry codes generally recommend implementing valuation arrangements to address and mitigate conflicts of interest in relation to asset valuation.

iii. *Risk management*: the reports also emphasise sound risk management practices as central to ensuring market confidence in the hedge fund industry is maintained.

iv. *Governance*: appropriate fund governance structures are recognised as essential to mitigate potential conflicts of interests between hedge fund managers, hedge funds that they manage and investors in the hedge funds.

v. *Shareholder conduct*: given the extensive debate in relation to the conduct of hedge fund managers in adopting "activist" investment strategies, in particular by the issue of traditionally "opaque" hedge funds combined with use of borderline actions (vote on shares borrowed for only this purpose, empty voting, masked action in concert, etc) which could be damaging, the HFWG argued that there should be best practice standards around shareholder conduct including more transparency.

vi. *Trading and business operations*: these recommendations are an acknowledgement that hedge funds have become increasingly complex organisations and that to operate effectively, it is essential that appropriate infrastructure is in place to support the business.

vii. *Compliance issues*: it is argued that commitment to the highest standards of integrity and professionalism within the industry is central if the hedge fund industry is to be held in high regard by stakeholders. The compliance framework must be supported by a culture of compliance throughout the organisation.

88. The areas covered by the voluntary codes are quite comprehensive. However two main issues should be highlighted, the lack of regulatory status and of consistent implementation. Moreover whilst there seem to be convergence in the international fora on the need of having international standards globally recognised and consistently applied, there are still several industry codes, not all of them promoting the same standards. Hedge funds should therefore take the necessary steps to adopt and apply the same standards, recognised globally. This would enhance transparency and risk management practices and address some of the risks outlined in Chapter 1 above.

89. As to the regulatory status of such private sector initiatives, it is worth mentioning that none of the industry codes have the force of law or of self-regulation[48]. They are simply recommendations to voluntarily adopt a set of standards. It is noteworthy that a November 2008 survey of over one hundred UK hedge funds found that while over 60% supported the HFWG initiative in terms of establishing standards for industry, less than 10% are prepared to sign up to these standards.[49] In addition, there has been no demand by investors of these hedge funds to adopt the standards.

90. If this survey is a true reflection of industry attitudes towards voluntary standards, it suggests that they will not be a success. One possibility to enhance industry compliance with best practices would be to encourage the four separate groups to work together in order to create one common hedge fund standard. Once such a standard is agreed upon, it may then be feasible to consider the possibility of creating an industry-funded self-regulatory organization that would assess compliance with the relevant standard by individual hedge funds.

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48 Self-regulation refers to the definition provided for in *Objectives and Principles of Securities Regulation*, IOSCO, May 2003, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf.

49 *UK Hedge Funds Uncommitted to Adopting Best Practice Standards*, Kinetic Partners, Press release, 17 November 2008, available at www.kinetic-partners.com/public/downloads/KP%20HFSB%20press%20release.pdf.

Key features of hedge funds' national regulation

91. This section of the Report is drafted on the basis of contributions provided by the members of the Task Force (under Annex 5) and, even if not exhaustive, tries to identify possible trends in national approaches to hedge funds.

92. The approaches vary from direct regulation of the funds (in term of pool of assets) or of the fund manager or the advisor to indirect regulation (limited to the financial intermediaries acting as counterparty). In certain cases a combination of approaches can be observed.

<u>Collective Investment Schemes (CIS) like regulatory approach</u>

93. A number of countries treat hedge funds as a subcategory of CIS. In these cases, hedge funds are subject to the CIS regulatory framework, at least to a certain extent and/or unless otherwise provided for in the legislation. For instance, the issue of annual financial statements, rules on prevention and management of conflicts of interests, record keeping obligations, fiduciary duties towards investors, governance and assets segregation.

94. The typical derogations provide that hedge funds:

- are not bound to the same investment limitations and risk diversification rules applicable to traditional CIS in several jurisdictions;
- can make use of special rules for asset valuation;
- can rely on a special disclosure regime.

95. The reasons for justifying such derogations often lie in the limits to the access by retail investors. Often, the public offering and solicitation to the purchase of hedge funds' units is forbidden or limited. In some countries the law sets forth a maximum number of investors for each hedge fund and/or minimum subscription thresholds aimed at ensuring that the investors are sufficiently sophisticated and wealthy. However, it is worth mentioning that in a number of European jurisdictions access to funds qualified (such as hedge funds) by the responding jurisdictions is fairly open to *quasi* retail investors.

<u>Registration requirements for managers and advisers</u>

96. In most members' jurisdictions hedge fund advisers or managers are subject to licensing, registration or eligibility requirements. In a number of countries the hedge fund manager is requested to comply with prudential and operational requirements aimed at ensuring that it has adequate resources to operate the funds and an organizational structure capable of ensuring market integrity and investor protection. These requirements are usually proportionate to the type and number of funds managed, the complexity of the investment strategies and the type of investors that the relevant funds envisage to target.

97. However, in a number of jurisdictions hedge fund advisers may rely upon exemptions excluding them from registration, provided that certain *de minimis* conditions are met. For instance, in some countries entities whose business is limited to the sole

management of hedge funds and/or funds targeting qualified investors, may trigger a different status and be subject to exemptions and lighter requirements.

Counterparties regulation

98. All Task Force members regulate counterparties to hedge funds. In particular, all members have implemented regulations to give effect to the FSF recommendations as subsequently detailed by the Basel Committee and IOSCO on financial intermediaries, including risk management procedures, compliance, etc.

Main differences in national approaches

99. The main differences in national approaches lie in the type, scope and conditions of the exemptions and derogations granted to hedge funds and hedge fund managers and advisers.

100. In particular, the freedom granted to hedge funds in terms of eligible assets, ability to engage in complex or leveraged investment strategies and derogate to risk diversification rules may range from a full discretion to a number of limitations, whose extent differs from country to country. For instance, diverse limitations apply on the use of derivatives, the level of leverage permitted, the borrowing restrictions and the categories of admitted assets. As regards the disclosure regimes, the main differences rest on the notion of public offering and the complementary concept of private placement, which significantly vary from system to system as well as the notion of sophisticated/institutional investor.

101. Registration requirements applicable to hedge funds and/or hedge fund managers and relevant exemptions also differ from country to country. In some jurisdictions hedge funds are not considered as CIS and are not requested to comply in full or in part with reporting requirements. In certain cases or under certain conditions, hedge funds may enjoy the status of an unregulated entity. As a consequence, hedge funds and relevant operators may be subject to a limited or no oversight by the regulator. In these countries, hedge fund and relevant managers may nevertheless be subject to anti-fraud provisions.

Key Themes

102. In the past recommendations by international organisations focused on indirect regulation through the bank counterparties of hedge funds. This helped in improving the risk management of banks vis-à-vis their hedge fund risks and to a limited degree, improved the understanding of regulators of the hedge fund industry and their potential risks.

103. In a large number of countries, direct regulation of the hedge fund managers exists. This may help regulators to take a view on the system and controls, governance and management of hedge funds and to get a limited amount of information on the underlying funds.

104. In very few countries there is direct regulation of the hedge funds themselves. Some argue that direct regulation of the funds, in addition to the manager, is helpful as certain information that is relevant for supervision is fund specific (i.e. risk profile/management, leverage, strategy).

CHAPTER 3 PRELIMINARY CONCLUSIONS AND POSSIBLE RECOMMENDATIONS

Preliminary Conclusions

105. The Task Force Report discusses the regulatory issues presented by hedge funds. It focuses on the recent financial crisis and issues around systemic risk but also touches on on-going regulatory concerns regarding hedge funds. It should be noted as discussed above that the recent financial crisis is not actually a "hedge fund crisis". Hedge funds have been affected by the crisis, like many other financial market players, leading to a significant contraction of the sector – which has taken place relatively smoothly so far. However issues have been raised about the possible role of hedge funds in amplifying the consequences of the crisis due to the need to quickly unwind positions of those facing liquidity restrictions and significant requests for redemption by investors.

106. There remain regulatory risks associated with hedge funds and their behaviours in markets. These have been outlined in some detail in Chapter 1.

107. In Chapter 2, the Report outlines the international standards and recommendations that have been published by the official and private sector in relation to hedge funds. In many areas, official international recommendations, including certain recommendations issued by IOSCO, already exist covering aspects such as portfolio valuation. These recommendations, however, are mostly focused on counterparties of the hedge funds (regulated financial intermediaries/prime brokers).

108. Despite these existing regulatory standards and principles, however, questions continue to be asked about how effective the existing regulatory standards and domestic regimes are and how well they have been implemented in practice. This is particularly true with respect to the reliance placed so far on private sector-led initiatives aiming at issuing codes of best practice. Even if the coverage of such standards, coupled with the official sector recommendations, is quite wide, open questions remain as to the effectiveness of such standards (given a low or unclear level of compliance by members of the industry) as well as the fact that they differ by jurisdiction to jurisdiction; in a segment of the market that regulators have signalled needs to be covered by globally applicable standards.

109. 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.

110. The Task Force identifies below a number of possible recommendations that could help to address the continuing concerns, either by re-iterating and strengthening existing standards and practices in national regulatory regimes and/or by suggesting additional requirements.

111. Some recommendations are not in the IOSCO remit to deliver alone but need work with banking standard setters (Basel Committee) and other regulators. There is also a general need to strengthen regulatory resources and expertise in the area of hedge fund regulation.

Possible Recommendations

112. Regulatory approaches currently operate through a combination of direct registration/ authorisation and monitoring/supervision of hedge funds and/or hedge fund managers and indirect regulation through directly regulated hedge fund counterparties (such as banks).

113. A number of these different regulatory "entry points" are described below and under each some detail is provided around the types of actions regulators could require – and in some cases already do require.

I. <u>Hedge Funds counterparties - Prime Brokers and Banks</u>

114. Prime brokers and banks, which provide funding and other services to hedge funds, are subject to both conduct and prudential regulation in all jurisdictions.

115. The Task Force supports the earlier recommendations issued by the FSF, supplemented in many cases by standards issued by the sectoral standard setters (in certain cases these are in the process of being updated).

116. The Task Force recommends that these counterparties should have strong risk management controls over their exposures to hedge funds and an ability to obtain sufficient information from hedge funds to properly evaluate their risks on an ongoing basis.

117. Securities regulators should support – through working with other regulators and their own contact with prime brokers and banks – obtaining non-public reporting of information on the prime brokers' and banks' most systemically significant and/or higher risk hedge fund counterparties, including:

- leverage by fund and strategy;
- liquidity profile by fund;
- un-encumbered cash/assets;
- broad strategy, performance history;
- long market value/Short market value and Cash;
- whether hedge funds have multiple prime brokers;
- fund behaviour after specific events (e.g. stress testing after significant market events); and
- margin requirements, terms.

118. Given the main transmission mechanism of systemic risks to the wider financial markets

is via the hedge funds' prime brokers and banks, the above information appears to be of significant value.

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?

II. <u>Hedge Fund Managers</u>

119. In the majority of jurisdictions, hedge fund managers are directly registered/authorised and supervised/monitored on an on-going basis. Their supervision allows regulators to put minimum regulatory requirements on these entities.

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

120. Regulatory requirements for hedge fund managers, applied in a number of jurisdictions, are in most cases in line with the guidelines included in the FSF recommendations, originally addressed to the private sector and already widely accepted. The upgrading of such guidelines as described below to officially supported regulatory principles could help to address the potential risks identified in Chapter 1.

121. The Task Force believes that progress towards a consistent and equivalent approach of regulators to hedge fund managers should be a high priority.

Do you support the need for progress towards a consistent regulatory approach to hedge fund managers?

122. The Task Force recommends regulatory oversight should be risk-based, focused particularly on the systemically important and/or higher risk hedge fund managers – possibly with a de-minimis cut-off.

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

a. Recommended approach to registration / authorisation

123. At ***registration/authorisation*** hedge fund managers should provide fundamental information, as deemed appropriate by the regulators, which would aid the regulators in achieving their primary objectives, namely:

- protecting investors; and
- monitoring systemic risk and risks to counterparties to hedge funds (prime brokers).

124. Some examples of the types of information regulators may require include:

i. Background of key management and investment personnel; organisation and ownership

ii. Assets under management

iii. Business Plan

iv. Services offered

v. Hedge fund investors targeted

vi. Fees charged

vii. Investment related affiliates

viii. Investment strategies utilised

ix. Risk tools or parameters employed

x. Identification of key service providers, such as independent auditors, sub-advisers and administrators

xi. Conflicts of interest

125. The information supplied through the registration/authorisation process would provide adequate transparency into the business of the hedge fund manager and should also be made available to all prospective clients prior to the execution of a subscription agreement or other investment management agreement.

126. The minimum information required should be consistent across all firms. If hedge fund managers are registered/authorised this will also permit each jurisdiction access and monitoring / inspection rights to the fund managers and its records.

Do you agree with the proposed list of information to be provided at authorisation/registration?

b. Recommended approach to ongoing monitoring / supervision

127. Regulators should consider whether (in view of the risk posed) it is appropriate, on an ***ongoing basis***, to require hedge fund managers[50] to meet the following key requirements:

i. A comprehensive and independent risk management function that considers risks across the whole of the hedge fund managers' business, including: market, liquidity, credit and operational risks and which also includes stringent

50 In certain jurisdictions (namely in certain European countries) funds can be organised as investment companies which do not appoint an external manager. In such a case, the requirements recommended above for the manager should be complied with by the investment company itself and by its managers.

stress testing of their positions. This includes measuring, monitoring and managing risk, including stress testing of portfolios for market and liquidity risk. Appropriate disclosure regarding risk should also be made to investors.

ii. A strong independent compliance function supported by sound and controlled operations and infrastructure, adequate resources and checks and balances in operations.

iii. The nine IOSCO principles on valuation remain valid[51] In addition, robust verification of fund valuations can be achieved for example through independent third party providers or strong independent overview from the hedge fund's governing body. In short, valuation procedures call for adequate segregation of responsibilities and thorough written policies.[52]

iv. Adequate segregation and protection of client fund assets through use of custodians and depositories that are, in appropriate circumstances, independent, and ensure investors' funds are protected.

v. The accounts of the fund manager and/or of each of the funds managed should be subject to independent audit on an annual basis.

vi. Some members of the Task Force also believe that adequate financial resources (capital requirements) are important to ensure that hedge fund manager can face the risks incurred in their activities and have less of an impact on the wider financial system. These prudential requirements should be broadly consistent with the type of capital that is required by firms with similar business profiles.

vii. Management and disclosure of conflicts of interest. Hedge Fund managers like other fund managers are subject to significant conflicts of interest (institutional and personal).[53] They need to manage such conflicts and provide full disclosure and transparency about such conflicts of interest.

viii. Compensation/remuneration structures and practices need to be subject to strong governance mechanisms and to manage conflict of interest issues

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51 *Principles for the Valuation of Hedge Fund Portfolios* — Final Report, Report of the Technical Committee of IOSCO, November 2007, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD253.pdf.

52 For example, (i) to verify the existence of assets and liabilities, (ii) to outline the manner and frequency of computing a net asset value based on U.S. GAAP or IAS, (iii) to outline the disclosure requirements of material net asset value related information to investors, (iv) to ensure valuation principles are standardized, including disclosure about fair value measurements determined based on common market participant assumptions (including liquidity), (v) to outline the manner and frequency for computing portfolio valuations for the purpose of internal risk monitoring, and (vi) to detail the procedure for the Financial Statement Close Process ("FSCP").

53 The first category included conflicts that affect the Hedge Fund Manager as an institution, such as investment/trade/brokerage allocation practices; undisclosed compensation arrangements with affiliates; undisclosed compensation arrangements with counterparties, etc. The second category includes individual conflicts, such as personal trading; personal investing; personal or business relationships with issuers, etc.

(outlined above) and to counter the short-term profit motives that are often inherent in hedge funds' operations. The standards here should align to those being developed by the FSF in its work stream on remuneration.

ix. Transparency: Hedge Fund managers should provide to their regulators certain information about the funds in their portfolio. IOSCO encourages industry associations to work with regulators to agree on the type of information and the way it is presented, in order to help regulators to consolidate and analyse information across different managers and funds.

x. Hedge fund managers should ensure there is proper disclosure to investors, amongst other things on the risks incurred, the conditions and/or the limits for redemption, the existence and conditions of any side letters and gating structures, fund's strategy and performance, including audited financial statements.

Do you agree with the proposed approach to ongoing supervision?

III. Hedge Funds

128. Some Task Force members would favour the introduction of regulatory requirements at the level of the (underlying) hedge funds to get an overall picture of the risks posed by the funds themselves. Such a direct regulation at the fund level could involve a registration/authorisation of the fund as well as on-going supervision of the fund. Some examples of the type of information that could be considered as possible requirements, at the entry point or on-going, include:

- Information on prime broker and depository, background on the persons managing the fund's assets and the fund's investment strategy;
- Regular data provision to regulators on the positions, leverage and high-level investment strategy of the fund;
- Information about relevant risks, particularly counterparty and market risks.

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?

IV. Industry Best Practice

129. The development of best practice remains of high value to securities regulators.

130. The Task Force encourages the development of a consolidated set of industry best practice standards which should supplement the above recommendations and should be globally consistent.

131. Hedge funds should fully adopt and adhere to industry best practice standards and should agree to a way in which regulators could be informed about the take up/compliance by individual hedge funds of/with the standards.

Do you agree that IOSCO should support that a set of globally consistent industry best practice standards is developed and subsequently monitored? How do you believe the take up / compliance could be monitored?

V. Other

Regulatory Resources and Cooperation

132. The Task Force believes that national regulators should build and focus resources around systemically important hedge funds, to enhance understanding of the sector, including (in a risk-based way) individual institutions, and help support greater cooperation and information exchange between regulators. Any additional data and information provided by hedge funds/hedge fund managers/counterparties need to be properly evaluated by the regulators. This requires the necessary know-how and resources. To avoid the risk of moral hazard, regulators should only collect the data and information they use and make clear that their oversight does not avoid hedge fund failures and is no substitute for strong risk management by all market participants.

133. Securities regulators should further enhance information sharing on market behaviours of specific internationally active funds to jointly investigate and, where necessary, enforce against potentially abusive or fraudulent market behaviour and activities. This exchange of information should be based on the principles established in the IOSCO MMoU and the ongoing work of the Standing Committee 4 of the Technical Committee of IOSCO, on Enforcement and the Exchange of Information.

134. Regulatory concerns have been voiced about the role of off-shore financial centres, where many of the underlying funds are registered – partly for tax reasons. The Task Force believes that all securities regulators - including those in such financial centres - should apply the above mentioned recommendations and ensure that appropriate information about the funds and its activities is maintained and properly audited for each fund registered in their jurisdiction. Regulatory cooperation, which the Task Force calls for above, would be further enhanced if all jurisdictions were able to collect key information items which could then be efficiently shared, consistent with the provisions of the IOSCO MMoU. Irrespective of where the underlying funds are established, fund managers/prime brokers/hedge funds themselves remain subject to the above-mentioned possible recommendations. Hedge fund managers should be able to obtain all the necessary information from their underlying funds – irrespective of location of those funds – so that hedge fund managers are able to evaluate the risks they are taking in their portfolio. If they cannot get the necessary information they should consider limiting the risks they are taking.

Do you have any comments on the proposals made?

Trading strategies/market abuse

135. Hedge fund managers and hedge funds, like other market participants, should maintain appropriate records of the trades performed on behalf of the fund and such information should be available to the regulators upon request.

136. Regulators of the markets in which the hedge fund/fund managers execute trades should be able to ask for appropriate disclosure to them and/or to the markets in order to be able to monitor market positions.

ANNEX 1

TABLE A: KEY AREAS - INTERNATIONAL RECOMMENDATIONS

	FSF			IOSCO		
Topics	**2000 Recommendations on HLIs**	**2007 Update of the 2000 Recommendations**	**2008 Report on Enhancing Resilience**	**1999 Report on HLIs**	**2007 Report on Portfolios Valuation**	**2008 Consultation Paper on Funds of Hedge Funds**
Risk management practices by regulated counterparties	Yes	Yes	Yes (with respect to credit exposure)	Yes	No	No
Risk management practices by hedge funds	Yes	Yes (encourage industry to review best practices)	No	No	No[54]	Yes
Better stress testing/liquidity risk	Yes	Yes (by core intermediaries)	Yes (by banks)	Yes (by regulated firms)	No	Yes (Managers should deal with liquidity risks)
Organizational structure and internal controls	Yes	No	No	Yes (of regulated counterparties)	Yes (in connection with valuation)	Yes
Improved margining and collateral practices	Yes	Yes	No	Yes (by regulated counterparties)	No[55]	No
Implementation of assets valuation policies	Yes (by both regulated counterparties and HLIs)	Yes (support to IOSCO Principles)	Yes (but with reference to financial institutions)	No	Yes (nine principles on this topic)	No
Due diligence on investments	Yes (by investors)	No	Yes (by investors)	Yes (by regulated counterparties)	No (yes on persons performing valuation)	Yes
Enhanced regulatory oversight	Yes (of credit providers)	Yes (on core intermediaries & consolidated counterparty exposures)	Yes (of supervised entities)	Yes (of regulated counterparties)	No	No
Enhanced market surveillance	Yes	No	Yes (on risks associated with financial innovation)	Yes (improving information flows about HLIs)	No	No
Enhanced public disclosure	Yes (particularly for off-shore centers)	Yes	Yes (but not specifically for hedge funds)	Yes	No	Yes (initial and ongoing)
Governance and/or conflicts of interests	No	No	No	No	Yes	Yes
Outsourcing	No	No	No	No	Yes	Yes

54 The Report recognises that portfolios valuation is critical to collateral requirements and risks profiles.
55 See footnote above.

TABLE B: KEY AREAS - INDUSTRY RECOMMENDATIONS

Topics	HFWG	PWG	MFA	AIMA
Disclosure of material information to investors	Yes	Yes	Yes	Yes
Segregation of responsibilities for assets valuation/independence of valuation function	Yes	Yes	Yes (suggested, but not recommended)	Yes
Policies and procedures to calculate NAV	Yes	Yes	Yes (NAV should be marketed at fair value)	Yes (ultimate responsibilities on directors)
Valuation procedures for hard-to-value/illiquid assets	Yes	Yes	Yes	Yes
Hedge Funds should follow U.S. GAAP or IFRS	No	Yes	Yes	No
Investments in hedge funds are only appropriate for sophisticated investors after careful diligence	No	Yes	Yes	No
Hedge fund manager risk management recommendations	Yes	Yes	Yes	Yes
Anti-money laundering procedures	Yes	Yes	Yes	Yes
Business continuity/disaster recovery plans	Yes	Yes	Yes	Yes
Fund governance	Yes	No	Yes	Yes
Shareholder conduct and proxy vote policy	Yes	No	No	No
Trading and Business Operations	Yes (dealing with operational risks)	Yes	Yes	Yes
Compliance issues	Yes	Yes	Yes	Yes

ANNEX 2

FSF RECOMMENDATIONS

FSF 2000 Recommendations	**Report of the Working Group on Highly Leveraged Institutions**[56]
Ten recommendations to address <u>systemic risks</u> and <u>market dynamics issues</u> arising from the activities of HLIs	1. Stronger counterparty risk management: All financial institutions acting as counterparties to HLIs should review their counterparty risk management arrangements against the recommendations of the international standard setters. 2. Stronger risk management by hedge funds: The practice for risk management should permeate throughout the hedge funds community. 3. Enhanced regulatory oversight of HLI credit providers: Supervisor and regulators should take appropriate steps to determine the extent of institutions' compliance with the of the international standard setters and take action where they identify deficiencies. 4. Greater risk sensitivity in bank capital adequacy regulation: (this recommendation was referred to the Basel Capital Accord reform). 5. Sustaining industry progress: The industry should progress in the area of refining measurements of potential future exposure, developing better stress testing and liquidity risk measures, collateral management techniques and use of external valuation. 6. Building a firmer market infrastructure: National authorities should improve harmonisation in certain areas, including documentation, collateral and valuation practices. 7. Enhanced public disclosure by HLIs: Support for the objective of enhancing public disclosure by HLIs and encourage regulators to review national requirements. The recommendation is addressed particularly to off shore centres. 8. Enhanced public disclosure practices generally: Support engagement in forward-looking and practical discussion of how disclosure practices should be improved. 9. Enhanced national surveillance of financial market activity: National authorities should strengthen market surveillance on HLIs, take appropriate preventive measures and improve market transparency, including foreign exchange and OTC derivatives markets data. 10. Good practice guidelines for foreign exchange trading: Market participants should review existing market codes and guidelines on foreign exchange trading to address existing concerns on trading behaviour.
FSF 2002 Report	**FSF Recommendations and Concerns Raised by HLIs: An Assessment**[57]
Preliminary conclusions and issues:	□ Bank supervisors and securities regulators should continue oversight of regulated firms' relationships with large counterparties (including HLIs) and consider repeating at some stage the BCBS/IOSCO joint review of counterparty risk

[56] http://www.fsforum.org/publications/r_0004a.pdf?noframes=1.
[57] http://www.fsforum.org/publications/r_0203b.pdf.

Counterparty risk management Flow of information from HLIs to counterparties and public disclosure initiatives Lack of reliable information Retail-oriented Hedge Fund Products Market functioning issues	management practices. The timing of the latter might be reflected on in the context of the FSF's vulnerabilities discussion. The FSF continue to encourage the hedge fund industry and regulated institutions to adopt the Multidisciplinary Working Group on Enhanced Disclosure (MWGED) recommendations. National authorities and international bodies should continue their monitoring of potential threats to market functioning posed by HLIs. National authorities should encourage foreign exchange market associations in their jurisdictions that have not already done so to adopt the good practices guidelines for foreign exchange trading. IOSCO should be encouraged to study the investor protection concerns that may arise in connection with hedge-fund products and retail investors and consider possible actions as necessary. Relevant authorities are encouraged to investigate how banks offering principal guaranteed hedge fund-related products measure and manage their exposures. FSF concludes that there have been no recent confirmed reports of instances in which HLIs have been at the centre of aggressive practices or have taken concentrated positions of a scale that have threatened the orderly functioning of markets.
FSF 2007 Report	**Update of the FSF's 2000 HLIs Report**[58]
Recommendations	1. Supervisors should act so that core intermediaries continue to strengthen their counterparty risk management practices. 2. Supervisors should work with core intermediaries to further improve their robustness to the potential erosion of market liquidity. 3. Supervisors should explore and evaluate the extent to which developing more systematic and consistent data on core intermediaries' consolidated counterparty exposures to hedge funds would be an effective complement to existing supervisory efforts. 4. Counterparties and investors should act to strengthen the effectiveness of market discipline, including by obtaining accurate and timely portfolio valuations and risk information. 5. The global hedge fund industry should review and enhance existing sound practice benchmarks for hedge fund managers in the light of expectations for improved practices set out by the official and private sectors.
FSF 2008 Report	**Enhancing Market and Institutional Resilience**[59]
Recommendation no. II.17: - Supervisors will strengthen their existing guidance on the management of exposures to leveraged counterparties.	Recent events have demonstrated the importance of disciplined management of counterparty credit exposures. Existing national supervisory guidance on counterparty exposures to hedge funds needs to be extended to exposures to other large, high leveraged counterparties, including other financial institutions and financial guarantors. Counterparty credit exposures to firms providing hedges or guarantees need to take account of the potential correlation of the creditworthiness of those counterparties with the risks of the assets being hedged, particularly in difficult market conditions.

58 http://www.fsforum.org/publications/r_0705.htm.

59 http://www.fsforum.org/publications/r_0804.pdf.

ANNEX 3

REPORTS OF THE IOSCO TECHINAL COMMITTEE

IOSCO 1999 Report	**Hedge Funds and Other Highly Leveraged Institutions**[60]
Recommendations to the regulated firms acting as counterparties of HLIs	This report makes recommendations regarding: (a) strengthening risk management processes at securities firms that act as counterparties to HLIs; (b) guidance to securities regulators on the scrutiny which should be applied to regulated firms dealings with HLIs and the means by which firms should be encouraged to adopt sound practices; (c) improving information flows about HLI activities to regulated counterparties of HLIs, regulators, market authorities2 and to the public more generally; and (d) the advisability of further work by IOSCO in cooperation with other interested parties, including the Basel Committee and private sector groups.

IOSCO 2003 Report	**Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds**[61]
Possible regulatory responses to ensure investors protection	Potential responses of the regulator may include: • prohibiting direct or indirect retail investment; • allowing limited indirect investment through a professional fund manager; • imposing additional competency and experience requirements on the manager; • additional attention to the due diligence applied by the manager of funds-of-hedge-funds when selecting hedge funds; • permitting direct investment but limiting it to more sophisticated investors, by imposing a minimum subscription level; • requiring additional disclosure about the risks associated with the investment and the strategies followed by the fund; • requiring investors to sign an acknowledgment of the risk/complexity warning; • placing greater emphasis on the proficiency of sellers of the hedge fund to understand the product before recommending it to their clients; • placing greater emphasis on the manager's internal control processes, including valuation procedures.

IOSCO 2006 Report	**The Regulatory Environment for Hedge Funds**[62]
Main conclusions from the survey	1. None of the responding members has adopted a formal, legal definition of the term “hedge fund.” 2. Hedge fund advisers are regulated in most of the responding jurisdictions: (i) some members regulate the adviser to the hedge fund, rather than the fund itself; (ii) many members regulate both the hedge fund adviser and the hedge fund; (iii) various members regulate the distribution of hedge funds, and/or the information. 3. Few jurisdictions report any significant “retailization” of hedge funds at this point in time, but some regulators anticipate that this is changing or may change in the future.

60 http://www.iosco.org/library/pubdocs/pdf/IOSCOPD98.pdf.
61 http://www.iosco.org/library/pubdocs/pdf/IOSCOPD142.pdf.
62 http://www.iosco.org/library/pubdocs/pdf/IOSCOPD226.pdf

	4. There have been some incidents of fraud relating to hedge funds in the responding jurisdictions, with the extent of fraud low in some jurisdictions but varying in member jurisdictions. In addition, some members noted that their regulatory regime for hedge funds was new and that as a result, there was no data on hedge fund fraud. Member jurisdictions continue to monitor for fraud in connection with hedge funds.

IOSCO 2007 Report	**Principles for the Valuation of Hedge Funds Portfolios[63]**
Assets valuation	The Report sets forth 9 Principles for the valuation of hedge funds' assets: 1. Comprehensive, documented policies and procedures should be established for the valuation of financial instruments held or employed by a hedge fund. 2. The policies should identify the methodologies that will be used for valuing each type of financial instrument held or employed by the hedge fund. 3. The financial instruments held or employed by hedge funds should be consistently valued according to the policies and procedures. 4. The policies and procedures should be reviewed periodically to seek to ensure their continued appropriateness. 5. The Governing Body should seek to ensure that an appropriately high level of independence is brought to bear in the application of the policies and procedures and whenever they are reviewed. 6. The policies and procedures should seek to ensure that an appropriate level of independent review is undertaken of each individual valuation and in particular of any valuation that is influenced by the Manager. 7. The policies and procedures should describe the process for handling and documenting price overrides, including the review of price overrides by an Independent Party. 8. The Governing Body should conduct initial and periodic due diligence on third parties that are appointed to perform valuation services. 9. The arrangements in place for the valuation of the hedge fund's investment portfolio should be transparent to investors.

IOSCO 2008 Report	**Funds of Hedge Funds[64]**
General conclusions	The Report: - globally confirms the conclusions of the IOSCO 2003 Report; - further points out that funds of hedge funds are largely regulated or authorized in the majority of SC5 jurisdictions, the applicable rules being generally based on the regime for traditional CISs as potentially completed by specific rules; - identifies additional investor protection regulatory issues given that <u>in a few areas, the regulation is either too light if not non-existent, or is too general</u>, which could raise concerns for regulators. This Report therefore proposes to potentially consider further work for the purpose of <u>developing guidelines</u> in relation to the methods that might be utilized by funds of hedge funds' managers in order to deal with the <u>liquidity risk</u>, and the <u>nature and the conditions of the due diligence process</u> to be carried out by funds of hedge funds' managers (in particular in relation to valuation) prior to and during investment.

63 http://www.iosco.org/library/pubdocs/pdf/IOSCOPD253.pdf.
64 http://www.iosco.org/library/pubdocs/pdf/IOSCOPD276.pdf.

IOSCO 2008 Consultation Report	**Proposed Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices[65]**
Methods by which funds of hedge funds' managers deal with liquidity risk	The manager should: - consider whether the fund of hedge funds' liquidity and that of the underlying hedge funds are consistent and appropriate and sufficient to meet any redemption or repurchase obligation. - consider the liquidity of the types of financial instruments held by the underlying hedge funds. - consider whether limited redemption arrangements (such as redemption gates, redemption deferrals) are consistent with the fund of hedge funds' aims and objectives, and comply with several conditions. - whether conflicts of interest may arise. - establish, implement and reviewed periodically an appropriate due diligence procedure for the purpose of investment into hedge funds. - consider a list of legal and reputational risks and elements to be constantly monitored:
Due diligence prior to and during investment : - managers' resources, procedures and organizational structures - conditions for authorizing the outsourcing of due diligence	- The manager should have: 1. a documented and traceable procedure for selecting hedge funds: 2. the adequate human and technical resources to implement this procedure, and 3. the resources, procedures and organizational structure allowing the fund of hedge funds' manager to deal with anomalies Before outsourcing any part of its due diligence to a person or entity, the fund of hedge funds' manager should: a) determine that any potential conflicts of interest; b) consider to what extent the outsourcing of due diligence is consistent with the IOSCO *Principles on Outsourcing of Financial Services for Market Intermediaries.*

65 http://www.iosco.org/library/pubdocs/pdf/IOSCOPD281.pdf.

ANNEX 4

INDUSTRY CODES

Key Themes of the HFWG and PWG Initiatives

1. <u>Disclosure</u>

HFWG Recommends:

- Establishing a framework for disclosure of material information to investors.
- The framework should cover commercial terms – including material "side letters"; fees; disclosure of factors which could impact on performance e.g. exposure to hard to value assets.
- Appropriate disclosure to counterparties.

PWG Recommends:

- Recommendations are drawn from the public company disclosure regime.
- Establishing a framework for the disclosure of material information to investors in order for them to evaluate the fund, including financial information, risk information and potential conflicts of interest e.g., recommends hedge funds provide annual audited GAAP compliant financial statements to investors.
- Provision of periodic performance information to investors e.g., investors should be given a letter or similar communication and risk report on at least a quarterly basis.
- Hedge funds and counterparties should agree, at the time they initiate their relationship, on the types of information that will be made available.

MFA Recommends:

- Providing prospective and existing investors with sufficient information to enhance their ability to understand and evaluate their investment. Disclosing risk information, if appropriate
- Periodically provide to investors performance data and risk information and deliver annual audit financial statements.
- Disclose, develop and maintain trade allocation policies, relationships with prime brokers involving potential material conflicts of interests, use of soft dollar arrangements.

AIMA Recommends:

- Considering when promoting services and marketing hedge funds: i. regulations on promotion and marketing; ii. preparing marketing materials; iii. targeting and attracting appropriate investors; iv. addressing taxation issues for the targeted investors; v. use of third party marketers; vi. anti-money laundering regulations; vii. special agreements with investors (“side letters”); and viii. on-going investor communications.
- Providing adequate disclosure of information to investors on a consistent and timely basis.

2. <u>Valuation</u>

HFWG Recommends:

- Adoption of a valuation policy outlining the fund's valuation procedures.
- Either appoint a third party to undertake the valuations or if that is not possible, ensure the valuation function is separated from portfolio management.
- adopt policies in relation to side-pockets (i.e., accounts which separate illiquid assets from the fund's more liquid investments).

PWG Recommends:

- Adoption and consistent application of an asset valuation framework.
- Establish a valuation committee with ultimate responsibility for monitoring compliance

with the fund's valuation policies.
- Segregation of functions between portfolio managers and those responsible for valuation.
- Third party administrators can assist in asset valuation but use of a third party should not be regarded as a total solution. System can be implemented for portfolio management to have input into valuation but final decision should rest with the valuation committee.
- Reporting (at least quarterly) of the percentage of fund assets at each level of the FAS 157 hierarchy of valuation difficulty (i.e., so that investors can understand the percentage of hard to value assets e.g., complex derivatives).
- Adoption of policies in relation to side-pockets.

MFA Recommends:
- Establishing policies and procedures to verify financial assets and liabilities and relevant periodic reconciliation to statements produced by independent sources.
- Establishing policies and procedures to perform periodic reconciliations of OTC derivatives with respective counterparties and maintain sufficient internal documentation of non publicly traded instruments related transactions.
- Adopting accounting standards to ensure that NAV is marked at fair value and determining frequency of evaluations.

AIMA issued 15 recommendations for hedge fund valuation, including that:
- The Governing Body of the fund should ensure adequate segregation of duties in the NAV determination process; if the investment manager is responsible for determining the NAV, and/or acts as the Fund's Governing Body, robust controls over conflicts of interest should be established.
- The Offering Document should explicitly name the party to whom responsibility for the calculation, determination and production of NAV has been delegated.
- The procedures enshrined in the Fund's Valuation Policy Document should be designed to ensure that the parties controlling the Fund's valuation process are segregated from the parties involved in the Fund's investment process.
- Wherever possible the valuation of each position in the Fund's portfolio should be checked against a primary and secondary price source. Any decision to use a pricing model should be approved by the Governing Body and should be properly justified by appropriate testing.

3. <u>Risk Management</u>

HFWG Recommends:
- Implementing a risk management framework setting out governance structure for risk management activities and one which specifies reporting lines.
- Risk framework should cover portfolio, liquidity, market counterparty, credit, operational and outsourcing risks.
- Creation of a segregated risk monitoring function to be handled by a dedicated compliance manager responsible for managing risk, establishing and maintaining risk policy manual and disclosure of the fund's investment and risk management approach.
- Conducting regular stress testing and scenario analysis of its liquidity position and impact of extreme market occurrences on the value of the portfolio.

PWG Recommends:
- Implementing a comprehensive risk management framework to measure, monitor and manage risk in accordance with the funds intended risk profile. The function should be placed under the supervision of a Chief Risk Officer or formal Risk Committee.
- Framework should measure the principal categories of risk (liquidity risk, leverage, market risk, counterparty credit risk and operational risk), adopt policies and procedures that establish monitoring and measurement criteria, maintain a regular and rigorous

process of risk monitoring, retain knowledgeable personnel to measure/monitor risk.
- Assessing the credit worthiness of counterparties and understand the legal relationships the fund has with brokers/lending/derivative counterparties and their affiliates.

MFA Recommends:
- Implementing risk management/measurement/monitoring processes appropriate to the size, complexity and portfolio structure.
- Having controls to protect integrity of information.
- Understanding and managing risk exposures across various portfolios and positions, including exposure to potential counterparties' default and to operational risks.
- Calculating, reporting and reviewing position-level market risk metrics, volatility metrics and be aware of the limitations of the metrics and models used for risk measurement, monitoring and management.
- Performing stress tests and monitor and manage current and expected future sources and draws on liquidity.

AIMA Recommends:
- Implementing strong procedures and controls, segregation of potentially conflicting duties (where possible), the management of business risks and the need for skilled and experienced personnel whether or not on an employed or externally retained basis. Ensuring integrity of risk monitoring function.
- Defining the investment decision-making process and ensuring that investment decision are consistent with defined strategy and risk appetite.
- Taking care to ensure that inducements do not create unacceptable conflicts of interest.
- Defining the way to measure leverage, monitoring liquidity of both individual positions and the overall portfolio and counterparties exposure.

4. <u>Fund governance</u>

HFWG Recommends:
- Responsibility for fund governance rests with the board which should meet regularly and adopt such established code of corporate governance as appropriate

AIMA Recommends:
- Determining the most appropriate structure for a Hedge Fund, taking into account inter alia the needs and preferences of the anticipated core investors.
- Careful analysis in the initial structuring of a Hedge Fund in order to avoid adverse consequences, delay and additional expense at a later stage.
- That the directors have relevant standing and experience to allow them to discharge their fiduciary and other duties; they should act in the interest of the investors and to disclose potential conflicts of interest.

MFA Recommends
- The Hedge Fund Manager should be governed by a person or group of persons, acting through a management committee, board of directors, or other body, or directly as officers or members of the Hedge Fund.

5. <u>Shareholder Conduct</u>

HFWG Recommends:
- Establishing internal compliance arrangements to identify, detect and prevent breaches of market abuse laws and regulations.
- Implementing a proxy voting policy.
- Funds should not generally borrow stock to vote.

6. **<u>Trading and Business Operations</u>**

PWG Recommends:
- Appointing a senior management member with responsibility for operations.
- Ensuring sufficient checks and balances in operations and systems.
- Ensuring sufficient infrastructure, automation and resources.
- Continual assessment of effectiveness of operational and internal controls.

MFA Recommends:
- Establishing management, investment, risk, and trading documented policies and practices appropriate for its size, nature, complexity and trading activities for each hedge fund; policies and procedures should also monitor software applications, data, and IT infrastructure and identify potential conflicts of interests.
- Imposing appropriate controls and monitoring to ensure that its portfolio management and trading activities are consistent with the allocation policies and trading parameters and carefully selecting and monitor any mission critical, third-party service providers performing key business functions.
- Developing a comprehensive BC/DR plan that establishes clear policies and procedures for internal personnel and external service providers to prepare for unexpected events and establishing contingency plans for responding to third parties' failure.

AIMA Recommends:
- Establishing sound practices relating to the creation of an investment process, investment dealing and portfolio risk management. The implementation of these processes will also depend on the portfolio size, complexity of instruments traded and strategy of the portfolio.
- Identifying sound practices for trade recording, trade settlement, movements of cash, pricing of portfolios, net asset valuations, client reporting, and maintaining appropriate information systems, business continuity.
- Carefully selecting and monitoring suitable service providers.

7. **<u>Compliance Issues</u>**

HFWG Recommends:
- Ensuring adequate documentation and training on compliance procedures, back-up/disaster recovery procedures, personal account dealing policies and client confidentiality.
- Periodically testing compliance procedures.
- Appointing a compliance officer independent of portfolio management function to oversee regulatory compliance.
- Ensuring internal compliance arrangements to identify and prevent market abuses.

PWG Recommends:
- Adopting a written code of ethics and compliance manual
- Ensuring there is a process for handling conflicts of interest
- Providing a training program to educate personnel regarding hedge fund manager's policies
- Ensuring there is a compliance function that includes a chief compliance officer
- Conducting an annual review of compliance framework

MFA Recommends:
- Imposing appropriate controls to ensure consistency of portfolio management and trading activities with the allocation policies and trading parameters.

- Developing and maintaining a written code of ethics on business operations and personal trading policies, including appropriate use of material, non-public information. Material aspects of this code and policies to be communicated to investors.
- Establishing written compliance policies and procedures that comprehensively address all applicable laws, rules, and regulations tailored to its specific business operations; senior management should be involved in the compliance program.
- As part of its compliance policies and procedures, periodically review the firm's relationship with each counterparty executing transactions to assess compliance with best execution.

AIMA Recommends:

- Adopting a written Compliance Manual setting out policies on key areas such as investment and trading policies, code of ethics on personal dealing, market abuse, conflicts of interest and the use of dealing commission in the UK to pay for research services.
- Complying with the regulatory environment within which it operates and the specific rules applicable to its business. Staff should be fully aware of the procedures and rules applicable.
- Appointing a senior individual to take responsibility for compliance oversight and implementing arrangements for the regular monitoring of business risks and for adherence to all compliance requirements.

ANNEX 5

REGULATORY APPROACHES AT NATIONAL LEVEL IN CONNECTION WITH HEDGE FUNDS

	Australia
Description	Hedge funds operating in Australia fall within the statutory definition of managed investments (collective investments) under the Corporations Act (CA), and hedge fund activity is regulated in the same way as other managed investments. The Australian regulatory regime does not define hedge fund or have hedge fund specific regulations. There are no restrictions on which managed investment schemes can be called hedge funds, and no distinction between managed investment schemes that are single strategy funds and fund of hedge fund operations.
Domestic funds	All hedge funds formed in Australia, or that specifically solicit Australia investors, are subject to regulation under the CA. The nature of the regulation will vary according to whether the fund has retail investors. In broad terms, regulation consists of: • licensing of the hedge fund manager; and • regulation of a fund involving retail investors as a managed investment scheme; • licensing of advisers. ***All funds – fund manager licensing*** A hedge fund manager must hold an Australian Financial Services Licence (AFSL), and comply with the obligations that apply to holders of AFSLs. These include general obligations to: i. ensure that the financial services are provided efficiently, honestly and fairly; ii. have adequate arrangements for managing conflicts of interest; iii. comply with the financial services law and licence conditions; iv. take reasonable steps to ensure that its representatives comply with the financial services law; v. have adequate financial, technological and human resources to provide the financial services and to carry out supervisory arrangements; vi. maintain competence to provide the financial services; vii. ensure that representatives are adequately trained; viii. have adequate risk management systems. How these obligations apply in practice depends in part on whether the fund has retail investors. ***Retail funds[66]- regulation as managed investment scheme***

[66] A fund is a retail fund unless it has a minimum entry requirement \$500,000, or all offers are made to qualified or professional investors.

	A hedge fund offered to retail investors must: a. be individually registered as a managed investment scheme To qualify for registration, managed investment scheme must have a governing document (constitution) that is legally binding on members and the fund manager (responsible entity). The constitution must cover such matters as consideration to be paid to acquire an interest in the managed investment scheme, the powers of the responsible entity to make investments or otherwise deal with scheme property, scheme borrowings, handling of complaints, fees and indemnities in favour of the responsible entity, member's withdrawal rights and how the scheme may be wound up. When registering a scheme, responsible entities need to describe how scheme funds will be applied and what investment strategies are likely to be adopted. Responsible entities of managed investment schemes are subject to a range of governance and conduct obligations, including requirements to: i. have either a majority of external (non-executive) directors, or a compliance committee comprised or a majority of external members; ii. have an approved compliance plan which is subject to annual audit; iii. prepare and lodge audited financial reports that comply with accounting standards; iv. value scheme assets at regular intervals; v. price interests in the scheme in a way that is independently verifiable, involves only limited managerial discretion, and is fair to all members of the scheme. Schemes can offer investors continuous withdrawal (redemption) rights for so long as a scheme remains "liquid" (that is, liquid assets[67] account for more than 80% of total assets). b. only offer interests through a complying Product Disclosure Statement that has been lodged with ASIC. A Product Disclosure Statement is a prospectus-like document, subject to similar content and liability requirements. ***Advisers*** Anyone who gives advice about hedge funds must hold an AFSL and is subject to the obligations that apply to all licensees that provide advice, including know-your-client and suitability rules.
Offshore funds	Offshore funds that merely transact in Australian markets are not subject to specific regulation under the CA. They are subject to the same market conduct provisions as all other market participants and users, such as the prohibitions on insider trading, market manipulation and other types of market abuse.

	Brazil
Legal sources	The domestic hedge funds are regulated in our jurisdiction by the CVM Rule 409/04. They are included in the *multimercado* (multi-market) group of funds in Brazil. These CIS have been

67 Liquid assets are defined to include marketable securities, such as Government bonds or corporate shares and bonds.

	regulated under similar principles and standards applicable for all domestic funds.
Main requirements	Thereby the Brazilian regulation demands for the domestic hedge funds industry: 1. Daily NAV information, monthly report concerning the fund portfolio, and annual details of its financial statements; 2. Two basic documents related to the fund: the by-laws (which contains all the investment characteristics and rules of fund operation) and the prospectus (sale document, focused on investment policy, risks involved and expenses to be incurred by the fund); 3. Possibility of investment in a wide range of assets, as long as it is allowed by the fund's by-laws; 4. Some conflicts are prohibited, such as: (1) acquisition of shares issued by the fund manager and (2) manager votes in the fund assemblies. All the possibilities of conflict not prohibited must be, otherwise, stressed in the fund by-laws and prospectus; 5. The by-laws of the fund should establish its target public, if qualified or retail investors, and the limits in terms of issuers and assets concentration, as well as other aspects of the regulation, including the need for a prospectus, are much stricter for funds targeted to retail investors. 6. All domestic hedge funds are registered at CVM internet site, even the so-called *exclusive* funds (the ones sustained by a unique shareholder). Its is also possible to consult the fund's information, such as, NAV, manager, by-laws and prospectus in CVM´s website; 7. The control of the risks assumed by the fund and disclosed to the investors must also consider the characteristics and impacts of derivatives, repos and quotas of other funds acquired, and also, in some cases, the fund counterparties; 8. The fund exposure to each derivative should be considered together with the exposure to the underlying asset (look through). It is also very important to note that, in Brazil, every OTC derivative must be registered in an authorized clearing house. 9. There is a general obligation imposed to the fund manager to pursuit the investors objectives and interests, being faithful to them and acting always in their benefit, also avoiding situations that might not be considered compatible with those attributions and responsibilities.
International hedge funds	On the other hand, international hedge funds are not enclosed by our regulation, except if they are offered to Brazilian investors resident in Brazil (CVM Orientation Regulation nº 33/05). In this case, the offer must be registered at CVM, and the quotas must be negotiated only through Brazilian authorized brokers. There is also the possibility for domestic investment funds (including hedge funds) to invest in international hedge funds, if respected some concentration and diversification limits (100% of its net assets for foreign government bond funds, 20% for multi-market funds and 10% for all other funds). This authorization was included recently in regulation through Rule CVM nº 450/07. In fact, it's possible to say that Brazilian investment fund industry is not significantly exposed to the international hedge funds. For instance, foreign allocations by Brazilian investment funds come close to R$ 450 millions (2008 November), which represents 0,04% of total assets under domestic management.
Liquidity constrains	Recently, in response to the new challenges stemmed from the financial crisis, Brazilian CVM increased the following up of funds with potential liquidity constrains. Those funds were selected considering its portfolio profile (investment in non-liquid assets, including hedge funds quotas), fund redemption characteristics, and recent consolidated demands for redemptions required in the last two months. In these cases, the fund managers were requested

New initiatives and issues	to report details about the liquidity conditions of the portfolio assets. In this report, it was demanded information about the sufficient period for funds under management to sell 25%, 50%, 75% and 100% of its net equity under fair value prices, considering the ongoing market conditions. Other new challenges also came out with the assets liquidity restrictions: 1. need to enforce a better alignment between the liquidity profile of assets and fund liabilities (redemption rules); 2. better disclosure to investors, considering the use of a simplified prospectus, in order to improve suitability of the products to investors, inspiring, therefore, more confidence in the industry and minimizing the effects of a reliance crisis; 3. establish new responsibilities and standards for hedge fund managers in relation to the due diligence procedures, especially regarding assets that are illiquid or issued privately. Another issue that, in our point of view, deserves attention in the current process of regulatory improvement is the need for the development of an independent organization, which may be considered responsible for providing acceptable closing prices for all assets purchased by funds. Currently, in our jurisdiction, there is not a central price provider used as a reference, which permit individual asset valuation by each fund manager, generating a lack of uniform pricing criteria, especially for illiquid assets. Finally, a matter that also concerns CVM – even not being a subject under our jurisdiction – is with respect to the off balance sheet leverage sought by many international investment banks through acquisition of hedge fund quotas, a problem that evidenced a real leverage, in these institutions, even higher than they were supposed to be exposed. In this context, the unknown leveraged assumed by market participations, akin to investment banks, hampers the confidence in the industry disclosed information, deteriorating the systemic risk awareness, both by counterparts, investors and regulators, affecting, therefore, the investment fund industry performance by the worsening of the reliance crisis that can, for instance, unleash redemptions shock waves.

	Canada
Securities legislation requirements **Registration** **Suitability** **Limited market dealers**	In Canada, hedge funds are distributed in different ways – under a prospectus, under exemptions in securities legislation that allow them to be sold without a prospectus and, in some cases, through linked products, such as principal protected notes (which have often been structured on a basis that they fall outside the scope of securities legislation). Hedge funds sold under a prospectus or through exemptions in securities legislation are regulated through a range of general securities legislation requirements: • Portfolio managers who manage the fund portfolios must be registered as advisers. Portfolio managers also have minimum capital, insurance, financial statement filing and other regulatory requirements. In addition, they must satisfy proficiency and experience requirements before they are registered. • Dealers who sell securities must be registered. • Dealers have an obligation to adequately assess suitability of products for their clients to ensure that they and their salespersons have sufficient proficiency and product knowledge of complex products like hedge funds. Self-regulatory organizations of dealers are responsible for monitoring that dealers and their salespersons are performing reasonable 'know your client' and suitability assessments in the distribution of hedge funds. • In Ontario and Newfoundland, firms are required to register as limited market dealers if they primarily sell hedge funds and other products that are sold without a prospectus (exempt products). Although limited market dealers are not subject to all

the regulatory requirements of an investment dealer, they are subject to some regulatory obligations, such as requirements to assess suitability of products and to keep appropriate books and records.

Limited distribution

- Hedge funds sold without a prospectus can be sold only to:
    - accredited investors who meet certain net income or financial asset tests;
    - investors who can make a minimum purchase in the fund of $150,000;
    - investors in certain jurisdictions[68] who receive a mandated form of disclosure and acknowledge the risk of the investment they are making. Investors have 2 days to change their minds about the investment and have certain rights of action if the disclosure contains a misrepresentation.

Disclosure

- Disclosure requirements apply, depending on how the hedge fund is sold:
    - funds of hedge funds sold under a prospectus are required to give full, true and plain disclosure about the fund;
    - hedge funds sold to accredited investors or investors purchasing at least $150,000 are not technically required to provide disclosure, although in the course of reviews we have done of hedge funds, we have found that some form of offering document is usually provided;
    - hedge funds sold under the offering memorandum exemption[69] must provide a specific form of offering memorandum to investors.

Financial statements

- Continuous disclosure (such as financial statements) must be provided by prospectus-qualified funds of hedge funds and, in some jurisdictions[70], by hedge funds sold under certain exemptions.

Compliance reviews

- Compliance reviews of advisers, fund managers and dealers are performed by compliance staff of the securities regulatory authorities and self-regulatory authorities using risk-based approaches. Compliance reviews assess the overall operational environment and compliance structure of registrants to ensure compliance with securities laws.

Pending changes to the regulation of hedge funds

Regulation of distributors of exempt products such as hedge funds

In some jurisdictions in Canada, a market intermediary selling hedge funds or other products without a prospectus (exempt products) must be registered as a limited market dealer. In light of the growing number of exempt products in recent years, the CSA is proposing to require the registration of exempt market dealers across Canada, under proposed National Instrument 31-103. This would require dealers that only distribute exempt products to be subject to the regulatory requirements of other registrants.

Registration of fund managers

Recognizing the role fund managers play in establishing, promoting and running investment funds and providing or overseeing a broad range of services (including fund valuation and registrar and transfer agency activities), the CSA is proposing to require the registration of fund managers, including hedge fund managers, under proposed National Instrument 31-103.

The registration requirements for fund managers and exempt market dealers would focus on ensuring that they:

- have the resources to carry out their functions, or to properly supervise the functions if they are contracted to a third party, and to provide proper services to investors;
- manage their conflicts of interest;
- have adequate capital and insurance to provide protection for investors and minimize the risk of loss and disruption to them;
- have sufficient proficiency and integrity to carry out their functions; and
- have appropriate books and records for their securities-related business.

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68 British Columbia, New Brunswick, Nova Scotia and Newfoundland and Labrador.

69 See footnote 1, in British Columbia, New Brunswick, Nova Scotia and Newfoundland and Labrador.

70 Under NI 81-106 *Investment Funds Continuous Disclosure* in Ontario, Quebec, Saskatchewan, Nova Scotia and New Brunswick, hedge funds that are not reporting issuers are still required to provide certain continuous disclosure to investors.

	Germany
Fund structure and investment restrictions	The German Investment Act (Investmentgesetz), which came into force in 2004, provides the legal framework for the establishment of Single Hedge Funds (known as "Funds with additional risks") and Funds of Hedge Funds (known as "Funds of Funds with additional risks"). Hedge Funds may be set up as a contractual mutual fund not having own legal capacity or in the formation of an investment stock corporation with variable capital, which is an open-ended corporate vehicle for collective investments (like a Luxemburg SICAV). *Single Hedge Funds* Single hedge funds are free from most investment restrictions. They must adhere to the general principle of risk diversification and their contractual terms must provide for either the use of short sales or leverage by using derivatives, equity lending or direct financing from the prime broker. They can invest in a broad catalogue of eligible assets, including all UCITS assets, silent participations (if the value can be determined), precious metals and commodity futures contracts traded on regulated markets, shares of investment funds and shares of listed real estate companies. The assets that German single hedge funds can not invest in are real estate (and equivalent rights), real property companies and commodities (other than precious metals). The investment in unlisted securities is restricted to 30 percent of the net asset value. *Funds of Hedge Funds* Short sales are prohibited for German Funds of Hedge Funds. There is also the general prohibition of leverage, but with an exception: Funds of Hedge Funds have the possibility to borrow up to 10 percent of their net asset value in the short term, if this is provided in the funds contract terms and the borrowing conditions are customary in the market. Funds of Hedge Funds have to invest at least 51 percent of their net asset value in target funds. Target funds can only be German single hedge funds as well as foreign single hedge funds with comparable investment policies. The target funds must be domiciled in States actively prohibiting money laundering. Furthermore, they may invest a maximum of 49 percent of the net asset value in liquid assets (bank deposits, money market instruments) or shares in funds, which exclusively invest in cash and money market instruments. The investment in derivatives is only allowed to hedge currency risk. For diversification purposes, the fund may not invest more than 20 percent in an individual target fund. It may not invest in more than two target funds of the same issuer or fund manager, meaning the individual person responsible for the allocation of the assets. Moreover, there is the prohibition of "cascades", that is, a Fund of Hedge Fund may not invest in target funds which themselves invest in other target funds.
Redemption	The contractual terms of Hedge Funds may provide that the determination of unit prices and the redemption of units will only take place on certain redemption dates, but at least once in each calendar quarter. The investor may be required to give notice of a redemption request with a period of 40 days (for Single Hedge Funds) or 100 days (for Funds of Hedge Funds) before the redemption date.
Distribution	*Single Hedge Funds* The public distribution of domestic and foreign Single Hedge Funds is prohibited. Distribution by way of private placement is possible but only by licensed financial institutions, as defined in the German Banking Act (Kreditwesengesetz). There is no definition of private placement in the German Investment Act. The term is used as a generic term for all marketing and selling situations not constituting "public

	distribution". The complementary term "public distribution" is defined in the Investment Act as marketing that is made by public offering, public advertising or in a similar manner. The terms "offering" and "advertising" comprise any action that draws the attention of a (potential) investor to the fund. Nevertheless, there will be no "public distribution" unless this "offering" or "advertising" is made publicly, that is when the attention of an undefined number of unknown persons is drawn to the fund (i.e. marketing through newspapers or television). However, the publication of information required by law, e.g. data for taxation and the mere mentioning of a fund, is not considered as public distribution. In this respect, no difference is made between professional and retail investors. The definition of "public distribution" is neither tied to the status of the investor (professional or retail) nor to the characteristics of the transaction, e.g. minimum subscription amounts. *Fund of Hedge Funds* Public distribution (also to retail investors) of domestic and foreign Fund of Hedge Funds is allowed. Foreign Funds of Hedge Funds may only be sold to the public in Germany if the fund is subject to effective supervision in its home country and if there is sufficient cooperation between the foreign supervisory authority and the BaFin. Foreign investment companies must notify the BaFin of the intention to publicly market foreign Funds of Hedge Funds. For all other foreign Funds of Hedge Funds a public distribution is not permitted; however a private placement as outlined above remains possible.
Disclosure requirements	Prior to the subscription of units by the investor, a full prospectus containing all information as prescribed by the German Investment Act must be handed over to the investor. This prospectus must also enclose the BaFin approved contractual terms (or articles of association in case of an investment company). In case of Fund of Hedge Funds, the prospectus must include additional information regarding the target funds (e.g. their strategies). It must also contain a warning note that the investor may suffer a loss up to the total amount of the invested money. Funds of Hedge Funds are also obliged to publish annual and interim reports, which have to be filed with BaFin upon publication. For both, Single and Funds of Hedge Funds, the issuer and redemption prices have to be published at least once per calendar quarter.
Custodian Bank	The assets of a German Hedge Fund are held by the Custodian Bank. This Custodian must be domiciled in Germany or be a domestic branch of a foreign bank and have at least 5 million in liable funds. The bank must be independent and acts exclusively in the interest of the investors. The Custodian is also obliged to monitor the adherence to the legal provisions and contractual terms.

	Italy
Legal sources, definition or description of hedge funds	Hedge funds are regulated under Legislative Decree No. 59/1998, the Ministry of Treasury Decree no. 228 of 1999 and the Bank of Italy Regulation of April 14, 2005, as successively amended. Italian law does not provide for a definition of hedge fund, but it classifies alternative vehicles of this type as "speculative funds" (*fondi speculativi*), which may be either open-end or closed-end funds. The fund is a separate pool of assets segregated from both the assets of the fund manager and the unit holders. Hereinafter the term hedge fund is used with the same meaning as speculative fund.
Authorisation requirements	The setting up of h.f. shall be authorised by the Bank of Italy, which should verify that: o the fund rules contains all required information (including fund name, duration, management company, custodian bank/prime broker, details on NAV calculation, costs and fees on unitholders/funds/manager, rules for winding-up, terms and conditions for the fund participation, permitted investments and strategy, terms and conditions for the profit distribution, terms and conditions

	for the subscription and redemption of units, publication of fund documentation, maximum level of debt and leverage); o the fund rules must expressly mention the risk of the investment and the fact that it is made in derogation from the general restrictions and prudential rules for limiting and spreading risks established by the Bank of Italy; o the manager is an authorised asset management company (see par. 3 below); o it is appointed an independent custodian (see par. 5 below).
Hedge funds manager	The management of hedge funds and funds of hedge funds is reserved to asset management companies authorised by and registered with the Bank of Italy. The Bank of Italy shall verify that the company is able to ensure a sound a prudent management of the funds. Criteria for licensing such companies include capital requirements, satisfaction of fit and proper tests, suitable internal organization and structure, no obstacles to supervision, competence to carry out the functions and duties. The Bank of Italy has the right to establish in which cases, in the light of the potential effects on financial stability, the managers of hedge funds shall limit their business exclusively to the management of hedge funds. The manager has a duty to act diligently, correctly and transparently in the interests of the unitholders and to prevent and manage conflicts of interests. Moreover, stricter provisions apply to the internal organisation, compliance function, risk management, and internal audit functions of hedge funds' managers.
Investment policy	Italian law does not impose predefined investment restrictions to hedge funds. The fund manager is free to choose the investment strategy and limitations applicable to the fund, provided that they are fully reported in the fund rules. Therefore, hedge funds are allowed to: (1) invest in a range of financial instruments and commodities broader than the investments of ordinary mutual funds (i.e., listed and unlisted financial instruments, bank deposits, real estate, receivables and instruments with a market price) and (2) carry out investment strategies not bounded by prudential rules of the Bank of Italy for ordinary CIS. However, if a fund invests more than 10% of its NAV in unlisted securities, such funds must have the form of closed-end funds (e.g., private equity and venture capital funds). Moreover, funds of funds may invest their assets in CISs, only provided that such CISs directly invest in financial instruments other than CISs. If the collateral released by the hedge fund against financing determines the transfer of ownership of the relevant assets in favour of the lender, the manager shall ensure through appropriate contractual terms and conditions that the amount of the collateral is not significantly higher than the lent amount and that a set off clause is included in order to unconditionally protect the fund against the risks of lender's default.
Custodian and Prime broker	The financial instruments and the cash of the fund shall be deposited with a custodian bank, which is responsible to verify compliance with the law (including in connection with the NAV calculation and the subscription and redemption of units). The custodian is liable vis-à-vis the fund manager and each unitholders for the failure to fulfil its duties. The custodian must be a bank with: (i) a legal seat in Italy, or an Italian branch of a bank with a legal seat in another EU country, (ii) minimum capital requirements of EURO 100m; (iii) proper experience and organisation. The custodian must be independent from the management company: a director or a manager of the manager vests the role of director or manager in the custodian. The appointment of a prime broker does not impact the functions and responsibilities of the custodian. Therefore, the custodian shall be able to monitor constantly the amount of

	the fund's assets and verify the collateral released in favour of the prime broker by the hedge fund. The agreement between the manager and the prime broker shall be delivered to the Bank of Italy.
Accounting	Fund management companies must publish their accounts on a early basis and keep separate accounts for each managed fund. An authorised audit company supervised by Consob must audit such accounts. In addition to the above, the fund manager must: a) keep a daily book of the fund in which the transactions entered into in the management of the fund and the transactions in relation to the issue and redemption of fund units must be recorded; b) issue a balance sheet of the fund within 60 days of the end of each financial year or of the shorter period in relation to which earnings are distributed; c) issue a half-yearly accounting report on the management of the fund within 30 days of the end of the half year; d) issue a prospectus showing the unit value of the units and the total value of open-end funds.
Participation	Hedge funds cannot be marketed through public offerings and cannot be listed. Participation is restricted to investors who are able to pay a minimum subscription price of EUR 500,000 per unit. The units of hedge funds cannot be fractioned. Moreover, there cannot be more than 200 investors per hedge fund. Participation in a hedge fund is regulated by the fund rules.
Disclosure	Since hedge funds cannot be offered to the public (see above) there is no duty to publish a prospectus. However, there is a duty to deliver the up-to-date fund rules to each subscribing investor. As mentioned, the fund rules must indicate the risks arising from the investment. It is noteworthy that the fund rules of an Italian hedge fund must, *inter alia*, mention: (i) the risks deriving from investments (if any) in foreign hedge funds (e.g.: if such hedge funds are managed from off-shore centers) and (ii) the maximum amount of loans and leverage. Moreover, the accounting documents shall be made available to the investors and to the public according to the modalities specified in the hedge fund' rules.
Asset valuation	The valuation of the hedge funds' assets are subject to the detailed criteria generally applicable to all types of fund, as provided for in the Bank of Italy Regulation. Moreover, special rules apply to hedge funds which have to assess the value of a purchased CIS whose NAV is not updated. In this case, the hedge funds can, if so provided for in their fund rules, valuate the CIS by making reference to its forecasted net value; then the hedge fund's NAV shall be recalculated once the final CIS NAV will be available.

	Japan
Description **Registration**	There is no clear definition of hedge funds in Japan. However, many hedge funds and private equities have the same characteristics as investment trusts and collective investment schemes (CIS), and are restricted by the Financial Instruments and Exchange Act, so that investor protection is ensured. To be specific, first of all, investment management corporations of investment trusts and CIS are, in principle, required to be registered as the financial business operator or the registered financial institution, regardless of whether their investment products are for public offering or private placement.

	Asset managers using investment trusts or CIS are also, in principle, required to be registered with the JFSA to ensure that investors are protected. The registered asset managers are required to fulfill accountability to the investors and to submit the business report, etc., from the viewpoint of protecting investors.
Exemptions	On the other hand, the asset managers using CIS which target only qualified financial investors are not subject to registration, but are subject to notification requirement. Those asset managers are exempt from accountability requirement, etc. In any of the above cases, managers are subject to supervision by the JFSA.
Other rules	Regardless of type of the funds, any person who conducts investment activity in Japan is subject to regulations such as those on unfair trading, tender offer, large shareholding, etc.

	Spain
Fund structure and investment restrictions	The Royal Decree 1309/2005, about Collective Investment Schemes (CIS) provides the legal framework for the establishment of Hedge Funds and Funds of Hedge Funds in Spain, developed by the Ministerial Disposition 1199/2006 and the Circular 1/2006[71], of the Comisión Nacional del Mercado de Valores, on Alternative Collective Investment Schemes. Hedge Funds may be mutual funds or variable capital companies. **Single Hedge Funds** Hedge Funds are free from most investment restrictions, that is, they have a flexible investment regimen. They can invest in any kind of assets or financial instruments including derivatives according to the principles of liquidity, risk diversification and transparency. The prospectus must establish the investment policy: the indebtedness limit (that can no be superior to 5 times the assets value taking into account all the funds received in cash); the additional leverage via repos, simultaneous financing, financing through the sale of borrowed securities and commitments arising from derivatives; or the limits on the assets exposure to counterparty risk with a given entity. Also, when the policy is to invest principally in other Hedge Fund, this must be disclosed explicitly in the prospectus. **Funds of Hedge Funds** They must invest, at least, the 60% on Hedge Funds registered in Spain, in a OECD countries or managed by a management company or similar registered in a OECD country with similar investment rules to those established for Hedge Funds in Spain, or in investment companies, portfolio companies and comparable vehicles and structures with similar investment rules from the same countries. This percentage may be attained by investment in derivative financial instruments and its measurement must be done according with a formula that makes the media and takes into account the new subscriptions, which cannot be invested immediately. According to the risk diversification principle, a Fund of Hedge Funds cannot invest more than 10% in the same Hedge Fund. They cannot invest in others Funds of Hedge Funds.
Redemption	The right for redemption can not be granted on all dates on which the net asset value is calculated provided that this is expressly envisaged in its prospectus but, at least, will

[71] English version in www.cnmv.es Legislation / Spanish legislation / Regulation by subject / Collective Investment Scheme.

	take place once in each calendar quarter, at the same time as the asset value calculation, at least, is performed; this frequency can be diminished to only once in six months when the investment policy demands it. They can fix a maximum amount for the redemptions in a fixed date and the obligation of giving previous notice of a subscription or redemption. In Hedge Funds only, when redemptions may be paid in kind, the company may established mechanism to avid conflicts of interest between unit or shareholders.
Distribution	**Single Hedge Funds** The marketability is limited only to qualified investors and there is a minimum investment of 50.000 Euros. They must have, at least, 25 unit or shareholders. **Funds of Hedge Funds** There are no restrictions in distribution also to retail investors.
Disclosure requirements	Prior to the subscription, the investor will declare, in written form that acknowledges the risks inherent to the investment except when they are professional investors. The prospectus, that must be handed over to the investor, will include information about subscriptions and redemptions, the general policy of collateral, the agreements to outsource functions, advisory contracts, investment and management strategy (special risks), policy of investment in liquid assets and of managing liquidity to cater for redemptions, limit of indebtedness and the additional leverage through repos, loans and transactions with derivative financial instruments, criteria for valuing the assets in their portfolios, and the maximum level of management and depository fees. The public periodic reporting, apart from general contents, has to include counterparty risks when disposing the collateral, portion of assets owned by staff, and amount of management and depositary fees. It also must reconcile any differences exceeding 10% between the estimated net asset value and the final net asset value as of the same date. The Hedge Funds only do have specialised reporting models.
Management Company and Custodian Bank	The Management Companies are not required to be devoted exclusively to managing Hedge Funds; they must have a program of operations and an internal control system describing specific controls and procedures applicable (stress-tests, simulations and mechanisms for overseeing the liquidity of the underlying investments so that redemptions may be settled properly); the capital will be the sum of the generally required plus the 4% of the gross fees revenues they obtain from management the scheme. If the determination of the net asset value is outsourced, the contract must ensure that the service provider´s valuations practices agreed with asset valuations methods required by the regulation and with the scheme prospectus. The Custodian Bank will be informed when a financial collateral arrangement with a third party (prime broker) takes place, and must agree with the qualitative, quantitative and operational criteria on which the management company bases the assessment and analysis of the investments.

	Switzerland
Background	Switzerland's role in the global single hedge fund business is minor, especially when compared to the Swiss market share in private and institutional asset management. Only a handful of the approx. 4'500 single hedge funds existing worldwide are domiciled in Switzerland. Therefore, Switzerland has not seen the necessity to deeply consider hedge fund regulation up to now, although the market behavior of foreign hedge funds investing in Swiss targets has been subject to some supervisory investigations. While the single hedge fund industry is small, Swiss funds of hedge funds account for one third of the assets invested in funds of hedge funds worldwide. These funds of funds are merely considered as usual investment funds targeting alternative assets and are thus mostly treated like e.g. equity funds without special regulatory oversight.

	Notwithstanding the small fraction of single hedge funds in their home country, Swiss banks are actively involved in the global hedge fund business by servicing them as prime brokers and custodians. Especially the large banking institutions are providing prime brokerage as strategic product and were even able to increase the market share during the recent turbulences. This business is mainly done in the UK and the US. While hedge funds are, as any other investor in Switzerland, subject to market behavior rules, they are generally not prudentially supervised and can, as such, operate without requiring a license or registration. Hedge fund managers may be subject to a license requirement (see below), while services like custody or prime brokerage can generally only be provided by licensed banks or brokers.
Legal Form	As hedge funds are legal entities, the general provisions of the Swiss civil and company law apply to them. In addition, they are governed by the provisions of the Federal Act on Collective Investment Schemes of 23 June 2006. For an organization of open funds, investment companies with variable capital (SICAV) or as investment vehicle arising out of a contract between the investors and the manager are common arrangements. Both legal forms give flexibility in regard of the size of the vehicle. As such, investments and redemptions are possible at any time, provided investors and manager agree. However, on application of the manager, the regulatory authority may restrict redemptions for up to five years. This allows for investments where the liquidity requirements necessary to enable redemptions at any time may conflict with the investment strategy of a fund. In contrast, closed funds, mostly in the form of a limited liability partnership (LLP), lock the investor into the fund for a longer period of time. Since the LLP gives the manager utmost flexibility in designing the relationship with the investors, this legal form is deemed advantageous for most hedge funds and private equity-vehicles and thus is very popular amongst them. As this flexibility and lock-in require special investor attention and capabilities, a LLP fund may be only distributed to qualified, professional investors.
Product regulation	Managing a hedge fund or providing services to it may require i.e. a banking or securities dealer license. For the fund itself, there is, however, no requirement to get registered or even licensed, as long as the fund is not offered publically. If they are, hedge funds under Swiss law need to be licensed by FINMA and are also subject to a leverage restriction. Yet, funds under foreign law do not require a license, if they are distributed to qualified and professional investors only.
Regulation of managers	Asset managers of hedge funds under Swiss law need to be licensed as fund managers. A Swiss manager of funds under foreign law may operate without license but need to be registered for AML/CTF supervision. He can, however, apply for one. It is only to be granted if the supervisory framework of the foreign jurisdiction is seen as equivalent to the Swiss requirements. Managers mostly opt for such a voluntary license when they regard a Swiss supervision as competitive advantage to acquire new investors. This may be the case if the fund targets investors of countries which mandate prudential supervision of investment vehicles.
Distribution, Point of Sale	While many countries try to achieve investor protection by their limiting choice to designated consumer-safe products, the Swiss framework puts focus on product transparency, sound investor information and risk awareness. Licensed asset managers need to be properly qualified and are required to show a five year track record in managing investments in the respective asset classes. In addition, the prospectus of hedge funds is part of the documents to be provided when applying for the license. FINMA checks this prospectus for completeness and consistency. It explicitly requires that the prospectus describes the risk inherent to the hedge fund, its leverage as well as its exposure to derivatives. The provisions further require that the fund investor is explicitly made aware of the risks.

	United Kingdom
Background	The UK is the centre for European-based hedge fund managers and we estimate that there are some 450 managers based here, managing approximately 80% of Europe's hedge fund assets. However, the hedge funds themselves are not located in the UK – the most common reason cited for this is beneficial tax treatment.[72] Regulation by the FSA therefore focuses on those entities over which we have jurisdiction: namely the managers and the banks that finance and transact with them in various ways (including trading and prime brokerage services). FSA regulation of hedge fund managers' is generally consistent with that applied to other asset managers and is based on a mixture of FSA rules (based on EU directives) and FSA principles for business. The FSA closely oversees a group of 40 of the larger managers from within a specialist supervisory team accounting for more than 50% of AUM. This team visits and performs risk-assessments on these firms. Smaller hedge fund managers in the UK are supervised like any other small wholesale market firm, through a series of reactive and proactive projects, firm visits, reviews of their regulatory returns and other information sources.
Main points of FSA regulation *Conduct of business*	**Consumer protection**: There is very limited direct retail investment in hedge funds, so focused consumer based regulation would not be proportionate.[73] Traditionally, hedge funds received approximately 80% of their capital from high net worth individuals and 20% from institutional investors. Over time this ratio has reversed and UK hedge fund managers now deal almost exclusively with institutional investors. High net worth individuals still invest by way of feeder funds and funds of funds (which are closed ended companies listed on the London Stock Exchange). Funds of hedge funds currently represent about 50% of the total investment in hedge funds. In addition, historically retail customers have only been able to access hedge funds indirectly, through institutional investors, (e.g. pension funds). Since 2004 they have been able to access them through Qualified Investor Schemes since, and since 2007 for funds of hedge funds from via the Listing Regime. **Prudential risk**: Hedge fund managers are covered by the Capital Requirement Directive (CRD) and as a result are required to maintain minimum capital resources to ensure that, if necessary, they can wind up in an orderly manner. As a result of the CRD, managers will either have to hold capital against operational risk or, if they are a limited licence firm, they will have to consider whether they hold sufficient capital to cover all risks (including operational risk) as part of pillar 2. The capital requirements mentioned under 'prudential risk' do not and cannot apply to any kind of performance or market risk **Market conduct and corporate governance**: We supervise managers to ensure they have adequate systems and controls for dealing appropriately with their investors and with the market. This includes procedures around customer identification and anti-money-laundering, handling of client monies and processes involved in the valuation of assets, management of conflicts of interest, risk management systems and use of market sensitive information. This ensures firms remain compliant with Principle 5 of our Principles for Businesses (a firm must observe proper standards of market conduct) and with relevant EU directives and our own statements with regards to market rumours.
Systemic risk / financial stability	As our approach to regulation focuses on those entities within our jurisdiction, we do not currently focus on the individual positions or exposures of the funds as these are generally located off shore and therefore outside of our regulatory remit. The FSA considers that the potential for hedge funds to generate systemic risk would emerge through distress at the regulated counterparties to hedge funds rather than at the hedge funds themselves. We address this risk through our supervision of the counterparties by ensuring that we understand their exposure to, and management of, risks posed by dealing with hedge funds. This involves close monitoring of counterparty and liquidity risk

72 Dan Waters, FSA Director of Retail Policy and Themes and Sector Leader, Asset Management, Speech to the Economic and Monetary Affairs Committee Public Hearing on Hedge Funds and Private Equity, 8 April 2008.

73 Most hedge funds are seeking substantial investments and have minimum entry requirements of well over £100,000 which is out of reach for any but the high net worth or institutional investor.

	management systems. In addition, we conduct a six monthly survey of prime brokers' hedge fund exposures which looks at the counterparty credit exposures of the 15 banking institutions which have the largest exposure to hedge funds. The results of this survey are used to inform our supervisory agenda both for the relevant bank counterparties and hedge fund managers.

	United States - SEC
Legal sources	Although hedge funds and their advisers are exempt from many of the requirements of the federal securities laws, they are subject to a number of provisions, including, most importantly, the antifraud provisions of the federal securities laws. The Securities Act of 1933 ("Securities Act"), the Securities Exchange Act of 1934 ("Exchange Act"), and the Investment Advisers Act of 1940 ("Investment Advisers Act") each provides the Commission with separate anti-fraud authority and authority to regulate unfair dealing by hedge funds or their advisers. In addition, hedge funds and their advisers are subject to certain US laws and regulations in addition to those in the federal securities laws.
Investment Company Act of 1940 ("Investment Company Act")	Hedge funds are not registered as investment companies under the Investment Company Act. To avoid registration and substantive regulation under the Investment Company Act, hedge funds rely on one of two exclusions from the definition of "investment company." The first exclusion is available to hedge funds that have 100 or fewer investors. The second exclusion applies to hedge funds that sell their interests only to highly sophisticated investors. To rely on either exclusion, the hedge fund must restrict its offerings so that they meet the requirements for non-public offerings (described further below).
Securities Act	The Securities Act provides an exemption from the registration o of securities offered and sold by hedge funds. One condition of such exemption is that , hedge funds may not offer their securities publicly or engage in a public solicitation. Instead, hedge funds generally sell their securities in private offerings. To meet the most commonly used regulatory "safe harbour" for conducting private offerings, hedge funds may sell their securities to an unlimited number of "accredited investors." Accredited investors include individuals with a minimum annual income of $200,000 ($300,000 with spouse) or $1 million in net worth and most institutions with $5 million in assets.[74] Hedge funds that seek to rely on the sophisticated investor exclusion from Investment Company Act registration may sell their interests only to "qualified purchasers," a standard with significantly higher financial requirements than those necessary for accredited investors. Hedge funds appropriately relying on a private offering exemption are not subject to the prospectus delivery requirements of the Securities Act.
Investment Advisers Act	Virtually all hedge fund advisers meet the definition of "investment adviser" under the Advisers Act. Under the Advisers Act, investment advisers must register with the Commission and comply with the provisions of that Act and Commission rules. Many hedge fund advisers, however, avoid registering with the Commission by relying on the Advisers Act's de minimis exemption under Section 203(b) of that Act. That section excludes from registration investment advisers that have had fewer than 15 clients during the preceding 12 months, do not hold themselves out generally to the public as an investment adviser and are not an investment adviser to a registered investment company. For purposes of Section 203(b), current Commission rules provide that investment advisers may count a "legal organization," such as a hedge fund, as a single client. Thus, an adviser may manage up to 14 hedge funds before being required to

[74] In December 2006, the Commission proposed rules that would define a new category of accredited investor that would apply to offers and sales of securities issued by certain private investment vehicles, including hedge funds, to natural persons. The proposal was intended to address the concern that the accredited investor qualification standards that are currently in place were not designed to take into account the changes in investor wealth and personal income that have occurred since the accredited investor standards were adopted or the complexity of hedge funds. These concerns are amplified for natural persons who may not have the financial sophistication and ability to understand the merits of investing in a hedge fund and the ability to bear the economic risks of making such an investment. The rules have not been adopted.

	register with the Commission as an investment adviser, so long as it satisfies the "no holding out" condition. A number of hedge fund advisers do register as investment advisers under the Advisers Act. Some are required to register because they have 15 or more advisory clients, or they advise one or more registered investment companies, and therefore are ineligible for the de minimis exemption. Others have registered with the Commission voluntarily because their investors demand it or for competitive reasons. The Commission has antifraud authority over all investment advisers, whether registered or not. For example, Rule 206(4)-8 under the Advisers Act prohibits advisers to pooled investment vehicles (including hedge funds) from defrauding investors in hedge funds.
Exchange Act	The beneficial ownership reporting rules under Sections 13(d) and 13(g) of the Exchange Act generally require that any person (including hedge funds and their advisers) who, after acquiring beneficial ownership of any equity securities registered under Section 12 of the Exchange Act, beneficially owns greater than five percent of the class of equity securities, file a beneficial ownership statement containing the information required by Schedule 13D or Schedule 13G. Hedge fund advisers also may be subject to the quarterly reporting obligations of Section 13(f) of the Exchange Act, which apply to any "institutional investment manager" exercising investment discretion with respect to accounts having an aggregate fair market value of at least $100 million in equity securities. Those hedge fund advisers subject to the reporting obligations of Section 13(f) of the Exchange Act also are subject to reporting obligations with regard to short sales. Specifically, Rule 10a-3T under the Exchange Act generally requires such advisers to file Form SH with the Commission following a calendar week in which such an adviser effected a short sale in a section 13(f) security. In addition, section 16 requires a hedge fund and its adviser who beneficially own more than ten percent of any class of equity security registered under Section 12 of the Exchange Act to disclose their ownership interest. Furthermore, hedge funds are also subject to the short swing profit provisions of Section 16(b) of the Exchange Act. Finally, hedge funds typically claim an exclusion from registration as broker-dealers under Section 15(a) of the Exchange Act based on the "trader" exception to the definition of dealer. Although the Commission generally does not regulate hedge funds as broker-dealers, it does oversee broker-dealers that may act as creditors of, or counterparties to, these funds. Many hedge funds use prime brokers, many of whom are broker-dealers registered with the Commission.
Certain Other Regulatory Requirements	Depending upon their activities, in addition to complying with the federal securities laws, hedge funds and their advisers may have to comply with other laws, including rules promulgated by the Financial Industry Regulatory Authority ("FINRA") and/or provisions of the Employee Retirement Income Security Act ("ERISA"). More specifically, broker-dealers that sell interests in hedge funds are subject to the requirements of FINRA rules, which regulate sales practices of FINRA members, including certain suitability matters. In addition, some hedge fund advisers are regulated as ERISA fiduciaries because they view employee retirement plans as attractive investors for the hedge funds they advise. Hedge funds also may be subject to certain regulations promulgated by the US Department of the Treasury, including rules relating to Treasury securities position reports, foreign currency position reports, and the prevention of money laundering. Moreover, hedge fund advisers are subject to certain state laws. For example, like the Commission, the states have antifraud jurisdiction to bring enforcement actions against all investment advisers, whether registered or not.

	United States - CFTC
Definition	The term "hedge fund" is not defined under the Commodity Exchange Act (CEA). Thus, the Commodity Futures Trading Commission (CFTC) has not adopted rules that are explicitly directed to hedge funds and hedge fund operators as separate categories of

	regulated entities. However, to the extent that hedge funds trade commodity futures or option interests and have U.S. investors, they would be considered to be a "commodity pool" under the CEA, and their operators or advisors would become subject to CFTC registration and/or reporting requirements as described below. In addition, all persons, including hedge funds, who trade on U.S. commodity futures and commodity option exchanges are subject to reporting requirements with respect to large, open positions held on regulated markets as well as limits concerning.
Registration Requirements	Generally speaking, while a commodity pool itself is not subject to regulation, as noted above, those who operate or manage a commodity pool must register with the CFTC as a Commodity Pool Operator (CPO), and those who make trading decisions on a pool's behalf must register as a Commodity Trading Advisor (CTA). Registration is not dependent on whether commodity interests are traded for speculative or hedging purposes, or on whether they are the predominant investment traded or advised. Once registered, a CPO or CTA must comply with certain disclosure, reporting, and recordkeeping requirements designed to ensure that prospective and current participants in commodity pools receive all the information that is material to their decision to make, or maintain, an investment in the pool. These include the following: • Prospective participants must receive information regarding the pool's investment program, risk factors, conflicts of interests, and performance data and fees. • Distributing unaudited period reports and certified annual reports on the pool's financial operations to the pool's participants. • Maintaining specified books and records for five years and making them available for inspection by the CFTC, National Futures Association ("NFA"), and the US Department of Justice. However, the CEA does not impose minimum capital or other financial standards on CPOs, nor does it impose restrictions on the financial interests that a commodity pool can trade. Hedge funds which carry out their transactions through organized exchanges are also subject to the rules and regulations of those exchanges. As of December 31, 2008, there were approximately 1,200 CPOs, a number of which may operate hedge funds , and 1,800 Commodity Trading Advisors (CTAs) registered with the CFTC, operating and advising approximately 1,700 commodity pools. In annual reports filed for 2007, the last full year for which data are currently available, CPOs reported total assets under management for commodity pools of approximately $800 billion, of which approximately seven percent represent direct investments in the futures markets.
Exclusions and exemptions from regulatory requirements and registration	CPOs and CTAs of hedge funds may qualify for exemptions from providing certain disclosures and reports to investors due to the nature of their investors. Because these exemptions are not predicated on whether the pool at issue is a hedge fund, the CFTC does not have data to show how many hedge fund operators or advisors operate pursuant to one of the available exemptions. However, most, if not all, hedge fund operators or advisors who are registered as CPOs likely operate pursuant to one of these reporting and recordkeeping exemptions. In addition to the exemption from certain disclosure and reporting requirements, a CPO may be exempt from registration, for a pool that it operates, if it: a. Operates only one pool at a time, does not receive any compensation or payment for operating the pool, does not advertise or solicit for the pool, and is not otherwise registered or required to be registered with the Commission b. Does not accept more than 15 participants or more than $400,000 in contributions for the pools that it operates; c. Limits participation in a pool to "accredited investors" and trades only a *de minimis* amount of commodity interests; d. Limits participation to certain financially sophisticated investors in its pool (such as CFTC and SEC registrants, insiders, and persons with $5 million in

	investments), regardless of how much commodity interest trading the pool does; or e. Is "otherwise regulated" as an SEC-registered investment company, banks and trust company, insurance company, and fiduciaries of ERISA pension plans. It is likely that this registration exemption also includes a number of entities that would commonly be considered to be hedge funds, though the CFTC keeps no data on such firms.
Responsibilities of the National Futures Association	The day-to-day monitoring of CPOs and CTAs is carried out by the NFA, a self-regulatory organization, and of which active futures industry registrants must be members. NFA's responsibilities include the registration processing function and review of CPO and CTA disclosure documents and pool financial statements. Consistent with the disclosure-based regulatory regime under the CEA, review of pool financial statements focuses on ensuring that they include all required information and conform to applicable accounting standards, but does not include an analysis of the pool's underlying transactions themselves. As part of its self regulatory responsibilities, NFA conducts on-site examinations of CPOs and CTAs on a routine, periodic basis. NFA generally examines CPOs and CTAs within two years of their becoming active, and every four years thereafter.
CFTC Enforcement Overview: Commodity Pools, Hedge Funds and CPOs	The CFTC takes its enforcement responsibilities with respect to CPOs, CTAs, and commodity pools very seriously. Whether registered or unregistered, exempt or not exempt, CPOs and CTAs remain subject to the CFTC's anti-fraud authority. Over the past eight fiscal years, the CFTC filed 73 enforcement actions involving commodity pools, hedge funds and CPOs. These enforcement actions typically involve investments in commodity pools, including self-styled hedge funds, in which the investors' funds were misappropriated or misused, or where investors were victimized by solicitation fraud involving misrepresentations of assets under management and/or profitability. The CFTC's Division of Enforcement currently has 27 pending litigations and approximately 26 additional open investigations and preliminary inquiries concerning commodity pools, hedge funds and CPOs. The majority of the CFTC's pool fraud cases have been brought against unregistered CPOs. These cases tend to involve ponzi schemes or outright misappropriation, as opposed to legitimate operations. In many instances, the CFTC works cooperatively with NFA, state regulators, criminal authorities and/or the SEC in bringing such actions. Sanctions in CFTC enforcement actions can include permanent injunctions, asset freezes, prohibitions on trading on CFTC-registered entities, disgorgement of ill-gotten gains, restitution to victims, revocation or suspension of registration, and civil monetary penalties. The CFTC has taken enforcement action in several well-publicized recent hedge fund frauds. Because these hedge funds engaged in futures-related activities, the CFTC took action to punish illegal conduct (whether it occurred during solicitation of prospective participants or as an aspect of trading by the pool), deter future violations, and seek recovery of monies taken from innocent victimized investors. The following two cases are illustrative: *CFTC v. Lake Shore Asset Management Limited*, No. 07 C 3598 (N.D. Ill. amended Feb. 19, 2008) (charging Philip J. Baker and the companies he controlled, registered CPO and CTA Lake Shore Asset Management Limited, the Lake Shore Group of Companies Inc., Ltd., Hanford Investments Ltd., and at least twelve commodity pools controlled by Baker, which operated as a common enterprise under variations of the name Lake Shore Alternative Financial Asset Fund; alleging that the defendants defrauded hundreds of commodity pool participants who collectively invested at least $300 million to trade commodity futures contracts on U.S. futures markets); *CFTC v. Hudgins*, No. 608CV187 (E.D. Tex. filed May 13, 2008) (charging George D. Hudgins with fraud in connection with his operation of a commodity pool, which traded exchange-traded commodity futures and option contracts, in the manner of a ponzi scheme; Hudgins' false representations included a declaration that the pool had an investment portfolio of approximately $80 million, when, in

	fact, the net value of the accounts associated with the pool was negative \$100,199.38; i.e., the accounts were operating at a loss; the accounts associated with the pool suffered losses of more than \$25 million from 2005 through 2007);
Surveillance Methods Used by the CFTC to Monitor Large Traders, Including Hedge Funds	In the CFTC's world of regulated futures exchanges, market integrity is essential to preserving the important functions of risk management and price discovery that the futures markets perform in the U.S. economy. The CFTC relies on a program of market surveillance to ensure that markets under CFTC jurisdiction are operating in an open and competitive manner, free of manipulative influences or other price distortions. The backbone of the CFTC's market surveillance program is its Large Trader Reporting System. This system captures end-of-day position-level data for market participants meeting certain criteria. Positions captured in the Large Trader Reporting System typically make up 70 to 90 percent of all positions in a particular exchange-traded market. The Large Trader Reporting System is a powerful tool for detecting the types of concentrated and coordinated positions required by a trader or group of traders attempting to manipulate the market. For surveillance purposes, the large trader reporting requirements for hedge funds are the same as for any other large trader. Using large trader reports, CFTC economists monitor futures market trading activity, looking for large positions that might be used to manipulate prices. Each day, for all active futures and option contracts traded on the regulated exchanges, surveillance staff members monitor the daily activities of large traders and key price relationships. In addition, CFTC market analysts maintain close awareness of supply and demand factors and other developments in the underlying cash markets through review of trade publications and government reports, and through industry and exchange contacts. These analysts also closely track the net positions of managed money traders as a class to monitor for any market irregularities or trends. The CFTC's surveillance staff routinely reports to the Commission on surveillance activities at regular closed surveillance meetings as well as on an as-needed basis. Market surveillance, however, is not conducted exclusively by the CFTC. Each futures exchange is required under the CEA to affirmatively and effectively monitor trading, prices, and positions. The CFTC examines the exchanges to ensure that they have devoted appropriate resources and attention to fulfilling this important responsibility. The CFTC staff's findings from these rule enforcement reviews are reported to the CFTC, and are publicly posted on the CFTC Website (www.cftc.gov). Furthermore, exchanges impose speculative position limits and position accountability levels, where appropriate, to guard against manipulation. For example, NYMEX imposes spot month speculative limits on its energy contracts. When the CFTC's surveillance staff identifies a potentially problematic situation, the CFTC engages in an escalating series of communications with the largest long- and short-side traders— which may be hedge funds—to address the concern. Typically, the CFTC's staff consults and coordinates its activities with exchange staff. This targeted regulatory oversight by CFTC staff and the exchanges is quite effective in resolving most potential problems. However, hedge funds normally close positions prior to the expiration month when manipulation is most likely to occur, and simultaneously establish similar positions in more distant months, because most do not have the capabilities or desire to make or take delivery of the underlying commodity. This process is referred to as rolling over a position. Given the CFTC's statutory role as an oversight regulator, and the exchanges' statutory responsibility to monitor trading to prevent manipulation, the law requires that the exchanges take the lead in resolving problems in their markets, either informally or through emergency action. If an exchange fails to take actions that the CFTC deems necessary, the CFTC has broad emergency powers to direct the exchange to take such action that, in the CFTC's judgment, is necessary to maintain or restore orderly trading in, or liquidation of, any futures contract. Fortunately, most issues are resolved without the need for the CFTC's emergency powers, as the CFTC has had to take emergency action only four times in its history.

Participation of Hedge Funds in Futures Markets	Futures markets serve an important role in our economy by providing a means of transferring risk from those who do not want it to those willing to accept it for a price. Traders who are trying to reduce their exposure to price risks, that is, "hedgers," typically include those who have an underlying commercial interest in the commodity upon which the futures contract is based. For example, futures contracts allow a bank to transfer its risk exposure to rising interest rates, a grain merchant to hedge an expected purchase of corn, or an oil refiner to lock in the price of its heating oil and gasoline output. In order for these hedgers to reduce the risk they face in their day-to-day commercial activities, they need to trade with someone willing and able to accept the risk. Data from the CFTC's Large Trader Reporting System indicate that hedge funds, and other professionally managed funds, facilitate the needs of commercial hedgers to mitigate their price risks, and add to overall trading volume, which contributes to the formation of liquid and well functioning markets. CFTC large trader data also show that hedge funds and other professionally managed funds hold significant arbitrage positions between related markets. These arbitrage positions are structured to profit from temporary mispricing between related contracts (*e.g.*, prices for October delivery vs. prices for November delivery) and, when structured as such, are unrelated to the overall level of futures prices. These arbitrage trades play an important role in keeping prices of related markets (and prices of related contracts within the same market complex) in proper alignment with one another. On the one hand, to the extent that hedge funds and other arbitrageurs judge these price relationships correctly, the arbitrageurs profit. On the other hand, if they misjudge these price relationships they may lose. The losses may be significant as market discipline may punish errors in market judgment severely. One notable market development in recent years has been increased participation by hedge funds and other financial institutions in futures markets for physical commodities. These institutions view commodities as a distinct "asset class" and have allocated a portion of the portfolios they manage into futures contracts tied to commodity indexes. The total investment in commodity linked index products by pension funds, hedge funds and other institutional investors has been estimated by industry observers to exceed $100 billion in assets. A significant portion of this amount finds its way into the regulated futures markets, either through direct participation by those whose commodity investments are benchmarked to a commodity index, or through participation by commodity index swap dealers who use futures markets to hedge the net risk associated with their dealing activities. Notably, although the percentage of participation by hedge funds has increased in recent years, commercial traders in these markets remain, by far, the largest segment of trading category.

ANNEX 6
LIST OF CONTRIBUTORS TO THE REPORT

- **Chairs**

  Commissione Nazionale per le Società e la Borsa (CONSOB, Italy)

  Financial Services Authority (FSA, United Kingdom)

- **Members**

  Australian Securities and Investments Commission (ASIC, Australia)

  Autorité des Marchés Financiers (AMF, France)

  Banking, Finance and Insurance Commission (BFIC, Belgium)

  Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin, Germany)

  Comisión Nacional del Mercado de Valores (CNMV, Spain)

  Comissão de Valores Mobiliários (CVM, Brazil)

  Commodity Futures Trading Commission (CFTC, United States)

  Financial Services Agency (FSA, Japan)

  Ontario Securities Commission (OSC, Ontario)

  Securities and Exchange Commission (SEC, United States)

  Swiss Financial Market Supervisory Authority (FINMA, Switzerland)

- **Observers**

  National Banking and Securities Commission of Mexico (CNBV, Mexico)

  IOSCO General Secretariat