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ECONOMISTS' OUTLOOK

Can Flower Power Protect Hedge Funds: Regulatory Developments for UK Hedge Fund Managers

Oliver Assersohn, Barrister, Outer Temple Chambers, London, UK

Introduction

Most funds renew the flowers in reception with such frequency that one foreign based regulator is said to know something is wrong if he sees that the floral decoration is no longer fresh. In this article I set out particular reasons why hedge fund managers ('HFMs') should be concerned about regulatory action and what, short of ensuring a fresh flower supply, HFMs can do to protect their positions.

The FSA's focus on HFMs

Amaranth; Long-Term Capital Management; Beacon Hill – these names form just part of the grim roll-call of hedge funds that have gone spectacularly wrong. The unpredictability of hedge funds –and the consequences of a heavily leveraged fund failing – have meant that the regulators such as the FSA are among those straining to detect shortcomings by HFMs.

In the general pool of funds, few can beat the market year-on-year. Over the last 10 years only about 27% of funds generally have been able to return more than the compound cost of borrowing the money for the investment at 5%.

Hedge funds are, in some ways, more likely to cause disappointment for an investor than the general pool of funds. Not all funds truly 'hedge' and most are fairly heavily leveraged (currently at around 2.4 times). To compound matters the fee structure of the funds (usually a '2% and 20%') arguably encourages a risk taking approach. In terms of cost, fund of funds introduce a further layer of fees.

The population of hedge funds is marked by high mortality rates: the half life of a fund is probably five years. 'Picking pennies up in front of a steamroller' is the almost clichéd description of what an investor in an hedge fund is doing.

In October 2007 the FSA issued Market Watch, a newsletter on market conduct and transaction reporting issues. The FSA had undertaken a programme of visits to a cross section of HFMs to review the controls that they had in place to mitigate the risk of market abuse. The FSA said that they were 'disappointed by some of what we saw. We will be following up with the firms visited and are also launching a programme of visits to a wider cross section' of HFMs.

The FSA has been subject to strident criticism in the UK press for its handling of Northern Rock. In circumstances such as these one would expect HFMs – a potential risk area – to come under particular scrutiny. In the remainder of this article I set out what, in my view, HFMs can do to allay concerns of the FSA.

Compliance culture

Jack G Gaine, President of the US Managed Funds Association said in an interview (in the context of bailouts) that the 'one characteristic of hedge funds that separates them from others ... would be the entrepreneurial nature and the single manager by and large'.

This entrepreneurial nature has often been fostered on the trading floor (or at least is unlikely to have been nurtured in the compliance department). There are obvious benefits to such a buccaneering spirit but it has traditionally been felt that the flip side of such characteristics has been to not place a great deal of emphasis on compliance issues.

Whatever the reason for it, the FSA commented in their recent newsletter that they were 'particularly disappointed at the level and standard of training' at some of the HFMs visited. 'While there are pockets of high-quality training, we found that sometimes the level of training was non-existent, low and/or of poor quality. Senior management must recognize their responsibilities to ensure that their staff are adequately trained'.

Some HFMs reported to the FSA that their size did not warrant a full-time compliance officer but say it is difficult to obtain adequate compliance support. Some questioned the quality of some of the consultants available. The FSA has recognized that there is some validity in these concerns but think that advisers with relevant sector experience are available.

The remuneration structures of some HFMs caused concern for the FSA. Some of these are related to the performance of an individual as opposed to the firm's

overall performance. Linking remuneration to overall performance was considered beneficial by the FSA because it reduces the incentive for staff to undertake market abuse for short term gain.

The FSA recommended that those who do not record their telephone calls consider the benefits of doing so. In the same report the FSA notes that HFMs often inadvertently receive inside information at one-to-one meetings with companies. Whilst of course this should not happen it does indicate the risk to HFMs that whatever procedures are in place within the office it is possible for information to be passed in private.

One way HFMs can allay concerns of the FSA is to emphasize the importance with which they view the regulatory regime. The ultimate responsibility for compliance with the market abuse regime lies with senior management. This should be demonstrated through the culture and controls found within the HFM's office.

Transparency

HFMs are expected to provide regular reports on the valuation of their funds to investors and to their prime brokers.

HFMs should set out the basis on which their funds are valued. The FSA state that this should start by 'establishing whether there is an independent valuation, but there is a need to go substantially beyond this, to cover policies and procedures such as the separation of duties between portfolio managers and back offices; the reconciliation of values between hedge fund manager, prime broker and administrator; price sources; and procedures for dispute settlement'.

Providing valuations of instruments to administrators does not nullify the risk so far as regulators are concerned if the administrators are not able to effectively challenge the valuations. This risk is increasing because of the greater activity of hedge funds in assets that are, by and large, illiquid and difficult to price.

An HFM should disclose the investment strategies that an HFM intends to follow.

In the past the FSA has been concerned that disclosure has not been made to potential investors about the fee structures and the methods of calculation used. This should include explanations of the associated complexities with hedge funds such as hurdle rates.

One of the most important concerns expressed by the FSA is that HFMs clearly set out the redemption policy (including any restrictions thereon). A particular concern of the FSA is the existence of side letters with material terms giving preferential redemption rights.

Insider trading

One of the major risks to which HFMs are exposed is trading on the basis of inside information. It is clear that in the FSA's view some insider trading would appear to be taking place (although not necessarily in hedge funds).

The FSA observes market cleanliness by looking at the extent to which share prices move ahead of significant, potentially price sensitive, regulatory announcements that companies are required to make to the market.

According to the FSA, the figures for FTSE 350 show 'a marked improvement in the level of untoward activity down from 19.6% in the period 1998-2000, to 11.1% in 2002/03 to only 2.0% in 2004/05. However, although the figures show that there is an improving trend there is still a lot of work to be done on mergers and acquisitions activity – for takeover announcements the figures were 32.4% in 2004 to 24% in 2000. The latest figures for 2005 are 23.7%'.

The FSA expects a list to be maintained of all securities on which the HFM has received inside information and in which, in consequence, trading is restricted. The FSA considers it good practice for HFMs to consider causal links between different securities and where a correlation exists, the list of securities on the list is expanded.

HFMs must have in place policies to ensure that their staff are aware of the need to maintain the confidentiality of leaked information about potentially price sensitive events. Both culture and training should seek to stamp this out. The FSA has stated that 'we will take action in situations where we identify the deliberate leakage of information or the dissemination of rumours'.

The FSA considers that it is necessary for all HFMs to have in place some independent monitoring of their market abuse controls and procedures. The FSA claims to have witnessed 'box-ticking' type checks of only limited benefit. Each firm should show that it is assessing the market abuse risks to which it is exposed and monitor the controls in place to manage those risks. Simple examples of monitoring include reviewing the reasons for trading securities which are being traded for the first time or which are traded before an unscheduled regulatory announcement.

Systems and controls can be implemented. Some have relevant controls built into the computer system for restricting or identifying market abuse. For example, such controls include restricted access to systems drives and prompts which indicate if a trade is about to be executed in a security listed on the restricted list.

Conclusion

Fresh flowers add a certain something to any reception area but are unlikely to induce a regulator to 'stop and stare' quite as profoundly as the (possibly apocryphal) regulator referred to at the beginning of the article did.

The FSA has indicated its seriousness of purpose in continuing to tackle effective regulation of HFMs. In consequence, HFMs would be well advised to address the substantive concerns the FSA has.

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International Corporate Rescue

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