

Mr Greg Tanzer  
Secretary General  
International Organization of Securities Commissions  
C/Oquendo 12  
28006 Madrid  
Spain

30<sup>th</sup> April 2009

Dear Mr Tanzer,

### **Public Comment on the Hedge Funds Oversight: Consultation Report**

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre") welcomes the opportunity to comment on the International Organization of Securities Commissions ("IOSCO") consultation report on "Hedge Funds Oversight" (the "Consultation").

The CFA Institute Centre<sup>1</sup> promotes fair, open, and transparent global capital markets, and advocates for investors' protection. The efficient functioning of capital markets are driven in no small part by the activities of hedge funds. However, in light of the systemic effects of the dysfunction in financial markets, IOSCO's review of hedge funds oversight is both timely and expedient. Moreover, given the global nature of the hedge funds industry, cooperation, communications, and further development of regulatory standards, established by both international authorities and industry bodies, are necessary to improve standards of practice and foster a level playing field. We are therefore supportive of IOSCO's efforts in this area.

#### **EXECUTIVE SUMMARY**

The Consultation addresses the risks posed by hedge funds; the current level and scope of hedge fund regulation; and preliminary recommendations of possible principles to mitigate the risks. Our primary observations are summarised as follows:

- First, it should be noted that not all hedge funds are alike, nor can they be lumped into a single category that suggests they are operating in a secretive and suspicious manner. The sector, in aggregate, is actually quite small globally with a total of approximately \$1 trillion U.S. under management. While some individual funds are quite large, the industry overall poses a comparatively minor threat to systemic conditions. In certain cases, these funds bring several benefits to financial markets. Most notably, hedge fund trading activities deepen market liquidity, improve price

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<sup>1</sup> The CFA Institute Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

discovery, and contribute to overall market efficiency. It should also be noted that many hedge funds have fallen victim to the financial crisis rather than being one of its primary actors. There have been many funds that have failed as a result of the recent turmoil.

- The potential risks posed by hedge funds cited in the Consultation comprise a lack of transparency, conflicts of interest (such as organisational structure and fee structure), and the potential for the use of excessive leverage causing problems for other market participants.
- A lack of transparency poses risks for fund investors, financial counterparties, and regulatory authorities, who may receive information of insufficient quality to make robust risk assessments, monitor exposures, and to conduct thorough due diligence. By extension, this has consequences for market efficiency. Accordingly, we advocate for greater transparency towards investors and hedge fund counterparties. In addition, regulators should have access to such information from hedge fund operators as they deem necessary to monitor and assess ongoing systemic considerations.
- Conflicts of interest are best addressed by a combination of clear and prominent disclosures to fund investors on an ongoing basis, proper separation and verification of the Manager's custody and operating functions, and sound internal controls to minimise the risk for malpractice and fraud.
- The potential for hedge funds to create systemic risk is a function of the hedge fund's relationship with the prime broker and other bank lenders, which serve to provide leverage to the hedge fund industry and subsequently expose the wider financial system to the aggregate leverage undertaken by such broker or bank. Accordingly, more stringent prudential regulation of prime brokers and other bank lenders (the 'indirect' approach to regulation of hedge funds) can be an effective method of mitigating the potential for systemic risk. Limits to re-hypothecation and separate custody of hedge fund assets from those assets of the prime broker may further strengthen the effectiveness of 'indirect' regulation.
- Existing regulatory arrangements for hedge funds include prudential supervision of regulated hedge fund counterparties (such as prime brokers); registration requirements for hedge fund managers in some jurisdictions; registration requirements for the funds (albeit in relatively few jurisdictions); and various codes of best practice established by industry associations. To date, there has been a lack of concern for investor interests in most of these industry-generated codes, and an inconsistent application of their standards, all of which permit a "pick and choose" approach to best practices. Moreover, whilst there has been some industry support for these industry-generated standards, the level of take-up remains disappointing. As advocates of self-regulation, the CFA Institute Centre has consistently urged the hedge fund industry to adopt and apply a consistent and verifiable code, or face formal regulation.

- Investor protection concerns are best addressed by managers putting in place effective controls and creating adequate segregations of key back office functions such as valuation and custody to minimise the potential for fraud or malpractice. Many industry codes of conduct fail to adequately address these issues on a consistent basis, suggesting that more formal regulatory registration requirements for hedge fund managers are needed as an additional level of oversight. Such requirements provide comfort that the manager is 'fit and proper' to manage client assets.
- Direct regulation of the hedge fund itself is likely to be inefficient for a variety of reasons. Hedge funds operators have the resources, means, and flexibility to circumvent direct regulatory requirements on the funds. For example, innovation in investment instruments and techniques, variability in the legal structure of the funds, and the ability for funds to swiftly relocate to alternative jurisdictions, are likely to render direct regulatory requirements on the fund itself less effective. Rather, a combination of hedge fund manager registration, effective self-regulation, and oversight of regulated financial counterparties such as prime brokers should provide supervisory authorities with the information they need to monitor the build-up of risks at the level of the funds.
- The CFA Institute Centre supports coordination, cooperation, and sharing of information between supervisory authorities, as well as a consistent, global approach to registration requirements, and an industry standard set of self regulatory best practices. This combination would help raise standards and improve the effectiveness of the regulatory approaches ultimately determined by the relevant authorities.
- CFA Institute Centre further supports the risk-based approach to regulation. This should involve regular risk-based oversight of large fund managers in combination with regular, if less frequent oversight of all managers. By focusing regular review on those entities that are potentially of systemic importance, the proper regulatory balance is achieved.
- We are also supportive of IOSCO's recommendation that a set of globally consistent industry best practice standards are developed and subsequently monitored. We therefore urge industry bodies and participants to ensure that these recommendations are put into practice in a timely and verifiable fashion.

Irrespective of the regulatory framework ultimately determined by authorities, the CFA Institute Centre believes that the industry should demand of itself a higher level of ethics and professional standards to serve investors' best interests. In our view, adoption, implementation, and active self-enforcement of the CFA Institute Centre's *Asset Manager Code of Professional Conduct*<sup>2</sup> would help address these issues and restore much needed trust in the hedge fund industry.

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<sup>2</sup> A new version of the CFA Institute Centre's *Asset Manager Code of Professional Conduct*, incorporating a revised section on risk management, will be available at <http://www.cfapubs.org/toc/ccb/2004/2004/4>

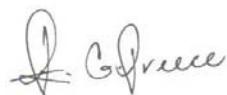
We attach our response that addresses the questions of the Consultation. Please do not hesitate to contact us should you wish to discuss any of the points raised.

Yours faithfully,



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The CFA Institute Centre is part of CFA Institute<sup>3</sup>. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, London, and Brussels, CFA Institute is a global, not-for-profit professional association of more than 94,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 131 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

Our detailed comments follow the order of the Consultation's questions.

## SPECIFIC COMMENTS

### 1. Overview of risks posed by hedge funds to capital markets - lessons drawn from the financial crisis.

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

Chapter 1 of the Consultation sets out the risks posed by hedge funds, split into 'inherent risks' and 'risks highlighted by recent market events'. This question focuses on the potential for manager remuneration structures to create conflicts of interest (or 'inherent risks') between managers and investors.

The remuneration structure for hedge funds typically comprises a management fee (such as 1% - 2% of net asset value) and an incentive fee (for example, 20% of realised profits). The fee structure may also include a "high-water mark". The Consultation notes that these fee structures may incentivize managers to inflate their results in the short run—for example, by overstating valuations or misrepresenting returns—or to engage in excessively risky investment strategies in order to boost fees. In the case of the latter, this may result in excessive use of leverage and a focus on short-term profits, which could have destabilising effects on financial markets.

The Consultation notes as mitigating factors good risk management, governance, controls, and transparency with regards to valuation policies. The question refers to the work of the Financial Stability Forum (FSF) in this area. The FSF has recently commented<sup>4</sup> that it will endorse a set of voluntary principles to reinforce sound compensation practices in the financial industry. These will be aimed at ensuring effective governance of compensation, alignment of compensation with prudent risk taking, effective supervisory oversight, and stakeholder engagement in compensation. We hope that these measures will sufficiently address the issues set out above.

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

The risks and issues related to hedge funds set out in the Consultation are categorised into inherent risks and risks highlighted by recent market events. Inherent risks comprise a

<sup>3</sup> CFA Institute is best known for developing and administrating the Chartered Financial Analyst curriculum and examinations and issuing the CFA Charter.

<sup>4</sup> See [http://www.fsforum.org/press/pr\\_090312a.pdf](http://www.fsforum.org/press/pr_090312a.pdf) .

perceived lack of transparency of hedge funds towards investors, counterparties, and regulators; and conflicts of interest, focusing on remuneration structures (addressed in the previous question).

*Transparency and conflicts of interest*

The lack of transparency is 'inherent' in that hedge funds' trading strategies may involve investment in over-the-counter or complex financial instruments which by nature are relatively opaque. They may also have a number of different financial counterparties, such as banks and prime brokers, each of which may not be fully aware of the exposures of the hedge fund to other counterparties.

More broadly, disclosure standards may vary. In some instances investors, financial counterparties, and regulatory authorities receive information of insufficient quality to make robust risk assessments, monitor exposures, and to conduct thorough due diligence. By extension, insufficient transparency creates risks that can have significant consequences for market efficiency.

In terms of transparency towards investors<sup>5</sup>, disclosure of key investor information, both prior to investment and during the holding period, is important to protect investors' interests. Presently, fund investors may lack sufficient information to enable them to conduct thorough due diligence. In our view, the appropriate information that fund investors need to make sound investment decisions includes (but is not limited to):

- the strategies used by the hedge fund (and the associated risks);
- fund performance information (using accepted performance standards for both absolute and relative returns);
- the background and experience of the hedge fund manager prior to subscription in the fund;
- a statement of portfolio holdings at regular intervals;
- valuation methods and relevant assumptions applied to those portfolio holdings; and
- audited financial statements, in addition to details on the auditor itself, at regular intervals for investors in the fund.

Additionally, in evaluating the methodology used to calculate fund performance, we recommend that the manager adheres to the Global Investment Performance Standards<sup>6</sup> (GIPS®). GIPS® is a set of standardised, industry-wide ethical principles that provide investment firms with guidance on how to calculate and report their investment results to prospective clients. Adherence to GIPS increases the transparency of performance reporting and thus improves investor confidence in the veracity of the reported information. Moreover, adherence to such standardised performance reporting principles helps mitigate the 'compensation risks' identified in the Consultation.

Investors also should require managers to disclose up-front any conflicts of interest, such as "side letters" (as cited in the Consultation), and any limited redemption arrangements

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<sup>5</sup> Transparency towards regulators and financial counterparties is addressed in section 3.

<sup>6</sup> CFA Institute created and administers the GIPS standards and partners with local country sponsors around the world to promote the GIPS standards. For more information, visit <http://www.gipsstandards.org/>

(or “gating structures”). Investors should be made aware of such arrangements prior to subscription via clear and prominent disclosures in the prospectus<sup>7</sup>.

Side letters may enable certain classes of investors to obtain specific or preferential agreements with the hedge fund manager with regards to the liquidity considerations and redemption policies of the fund. To mitigate any such conflicts of interest, it would be in investors’ best interests if the Manager disclosed, where possible, the nature and potential effect of these arrangements, and made such side agreements available to all clients, even if at higher prices. Transparency regarding conflicts of interests protects investors by providing them with the information they need to evaluate the objectivity of the manager’s actions.

The Consultation also notes that investor protection may be jeopardised both by poor or inadequate internal controls at the level of the hedge fund manager, as well as by insufficient segregation of functions. Both cases give rise to operational risk which can increase the propensity for malpractice and/or fraudulent activity. It is therefore in the best interests of investors that managers put in place robust systems and controls, adhere to documented compliance policies, and separate operating functions such as risk management, custody, administration, and valuation. In many cases, best practice would be to outsource these functions (particularly custody and valuation) to independent third-party providers, thus minimising the potential for conflicts of interest and malpractice.

#### Risks highlighted by recent market events

This section focuses on the potential for hedge funds to create systemic risk, for which the transmission mechanism is the hedge fund’s relationship with the prime broker. In this capacity, the Consultation discusses leverage, and the manner by which hedge fund activities amplify pro-cyclicality in the financial system.

First, it should be noted that hedge funds bring many benefits to financial markets. Most notably, hedge fund trading activities deepen market liquidity, improve price discovery, and contribute to overall market efficiency. It should also be noted that hedge funds have not been the primary actors in this financial crisis, measured by the limited market effects of fund failures.

However, in light of recent market events, some believe that hedge fund activities can amplify inherent pro-cyclicality in the financial system<sup>8</sup>. Just as leverage can augment market upswings, de-leveraging, fuelled by investor redemption requests, can exacerbate market downswings.

Traditionally, hedge funds’ losses were considered to have been borne principally by their investors and immediate counterparties, and therefore not the focus of market regulation. However, in light of the potential pro-cyclical effects stemming from their activities, their

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<sup>7</sup> These issues are also addressed in CFA Institute Centre’s response to IOSCO’s consultation on funds of hedge funds at <http://www.cfainstitute.org/centre/topics/comment/2009/pdf/090106.pdf>

<sup>8</sup> The U.K Financial Services Authority’s “Turner Review”, published in March 2009, notes that “*Hedge fund activity in aggregate can have an important pro-cyclical systemic impact. The simultaneous attempt by many hedge funds to deleverage and meet investor redemptions may well have played an important role over the last six months in depressing securities prices in a self-fulfilling cycle.*”

use of leverage<sup>9</sup>, and their relationships with regulated and systemically important banking institutions, there may be greater potential for the impact of fund losses (or fund failure) to go beyond the confines of fund investors.

The systemic relevance of hedge funds is primarily determined by leverage. The extent to which hedge funds leverage their operations is dependent upon the extent to which credit is extended to them from the prime broker or other bank lender. The relationship between the hedge fund and the prime broker acts as the primary transmission mechanism for the pass-through of risk from hedge funds to the financial system. Therefore, the greater the degree of leverage extended to hedge funds, the greater the counterparty risk borne by the prime broker, and hence the greater the potential for systemic risk in the greater financial markets.

For example, the combination of a hedge fund leveraged to several multiples of capital and declining asset values (corresponding with large redemption requests) may expose the prime broker to large losses. These losses may then be transmitted to the wider financial system as the prime brokerage contracts the supply of credit to other financial institutions. It follows that the key to mitigating systemic risk, therefore, is to control the extent of prime brokers' lending and counterparty exposures to hedge funds.

We believe that prudential requirements for prime brokers (the 'indirect' approach to regulating hedge funds) can be an effective method to mitigate the potential for systemic risk arising from hedge funds activities. These (and other) regulatory arrangements are discussed in section 3.

## 2. Overview of the current level of regulation of hedge funds

As the Consultation notes, previous recommendations by international organisations have focused on indirect regulation of hedge funds via prudential requirements on prime brokers and other bank lenders. Requirements regarding (among others) capital adequacy and liquidity have helped strengthen bank counterparty risk management. As noted above (and discussed in the subsequent section), we remain supportive of this type of oversight.

The Consultation notes that many countries also impose regulatory requirements on the hedge fund manager (the United Kingdom is a prime example). Typically, managers are required to register with the home country regulatory authority and provide certain information to demonstrate that they have the appropriate resources and organisational structure consistent with ensuring investor protection. In some countries (albeit few), there is direct regulation of the funds themselves. We comment on the merits of the different regulatory approaches and the proposals put forward by IOSCO in section 3.

The Consultation also highlights the various codes of best practice issued by industry bodies, such as the Hedge Funds Working Group (HFWG), President's Working Group on Financial Markets (PWG), Managed Funds Association (MFA), and Alternative Investment

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<sup>9</sup> The U.K FSA's Turner Review notes that hedge fund leverage is relatively low compared to banks, estimated in the report at approximately two to three. However the degree of leverage – recorded explicitly and embedded in the financial instruments held by the funds - can vary significantly between funds. For example, the Turner Review notes that convertible or fixed income arbitrage funds use significantly higher aggregate leverage than the relatively low average level.

Management Association (AIMA). We have commented on both the HFWG and PWG codes and found both less than adequate, particularly as it relates to recognizing the pre-eminent interests of fund investors. We also draw attention to the CFA Institute Centre's *Asset Manager Code of Professional Conduct*<sup>10</sup>, which sets forth a framework for asset managers (including hedge fund managers) to provide services in an ethical and professional manner and to fully disclose key elements of these services to clients.

As noted in the Consultation, the key themes addressed by these industry codes include disclosure; asset valuation; risk management; governance; shareholder conduct; trading and business operations; and compliance issues. However, although comprehensive, not all of these codes promote the same standards, resulting in both gaps and overlaps between the different codes. Most importantly, to date there has been a lack of consistent application of the standards promulgated by these codes, resulting in a selection of "pick-and-choose" best practices. Moreover, whilst there has been broad support for these standards, industry take-up remains disappointing. For example, the Consultation notes that in the United Kingdom, 60% of hedge funds supported the HFWG initiative yet less than 10% are prepared to sign-up to abide by these standards.

Consequently, we strongly urge the industry to develop, accept, adopt, and apply a consistent and verifiable code or face formal regulation. Irrespective of the regulatory framework ultimately determined by regulatory authorities, the CFA Institute Centre believes that the industry should demand of itself a higher level of ethics and professional standards to serve investors' best interests. In our view, adoption of the CFA Institute Centre's *Asset Manager Code of Professional Conduct* would help address these issues and restore much needed trust in the hedge fund industry.

### **3. Preliminary conclusions and possible recommendations**

#### **I. Hedge Funds counterparties - Prime Brokers and Banks**

*Q: 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?*

As the Consultation notes, prime brokers and banks (i.e. hedge fund counterparties) are subject to conduct and prudential regulation in all jurisdictions. Accordingly, they are (or should be) able to obtain sufficient information from the hedge funds they transact with in order to monitor exposures and to conduct appropriate risk management.

The Consultation notes the information that banks and prime brokers should have access to with regards to their hedge fund clients, which includes (among others): leverage by fund and strategy; fund liquidity; unencumbered cash/assets; fund strategy and performance history; aggregate long and short positions; results of stress-testing; margin requirements; whether hedge funds have more than one prime broker, and so forth.

The CFA Institute Centre shares the view that regulated counterparties are well placed to supply supervisory authorities with the information they need to monitor hedge fund

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<sup>10</sup> See CFA Institute Centre for Financial Market Integrity, "Asset Manager Code of Professional Conduct", at <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n4.4008> .

activities, albeit on a firm-by-firm basis. In addition to the above types of information, regulators (in addition to fund investors and lenders) would benefit from timely data on net asset value calculations and related methodologies and assumptions. Combined, this information would enable supervisors to monitor movements in fund values and calculate simple leverage ratios, so that they can identify the build-up of risk.

More generally, greater transparency is needed to improve prudential supervision. In some cases, limited disclosures by hedge funds have made it difficult for lenders and therefore regulators to assess the true degree of leverage carried by individual funds. Moreover, the commingling of hedge fund assets with those of the prime broker further obfuscated the monitoring of fund investments and performance. Consequently, prudential authorities may have lacked the ability to effectively monitor the exposure of hedge funds to the financial system.

The CFA Institute Centre also supports strong risk management controls at prime brokers and banks. This is of particular relevance having regard to the capacity of prime brokers to pass through risk from hedge funds to the wider financial system.

In particular, the potential for 'systemic' risk can be better managed by reducing the nature and extent of the inter-relationships between the prime broker and the funds to which it extends credit. These inter-relationships relate to the use of cross-collateralisation and the commingling of fund assets with other assets of the prime broker, which may then be re-hypothecated.

There are two main concerns arising from these inter-relationships. Firstly, re-hypothecation can transmit systemic risk. For example, suppose that the prime broker engages with a fund ("fund A") by lending capital that has been raised from a third party, using as collateral the assets of another fund ("fund B"). Failure of fund A could negatively affect the prime broker's solvency, which in turn would have a detrimental impact on fund B. In light of the systemic risks identified (and most notably exemplified in the case of Lehman Brothers in Europe), and the implications for investor protection, we recommend that the authorities give due consideration to whether a ceiling on re-hypothecation would be appropriate. Such a ceiling would be measured by the level of the fund's indebtedness to the prime broker. However, regulators also should ensure that they are able to effectively monitor the level of lending to individual hedge funds to help prevent making re-hypothecation a systemic issue.

Secondly, the commingling of the fund's assets with the assets of the prime broker increases the potential for systemic risk and fraud. As per the above scenario, should the prime broker suffer losses through exposure to another of its counterparties, it may be difficult for the hedge fund in question to secure the assets held in its custody account if those assets have been commingled and cross-collateralised (the extent of this risk may vary according to prevailing laws in different jurisdictions). Therefore, it may be prudent to limit the extent to which assets held in custody can be commingled by the prime broker. It follows that the most prudent approach would be to ring-fence the assets held in custody at the prime broker, or, preferably, to outsource the safe-keeping of assets to a third-party custodian. In practice, the benefits of limiting commingling and re-hypothecation ceilings would need to be weighed against the associated costs. However, in light of the potential for systemic risks and the need to protect investors we recommend IOSCO carefully consider the appropriateness of these suggestions.

Moreover, the financial crisis has reinforced the need for strong risk management on the part of all financial market actors. We are fully supportive of efforts to improve risk management processes and procedures for managing hedge fund assets, which would be best achieved through industry-wide adherence to an accepted code of conduct based on best market practices, such as the CFA Institute Centre's *Asset Manager Code of Professional Conduct*. Best practice would require adherence to firm-wide compliance policies and procedures to mitigate operational risks, adoption of robust investment-selection processes, and risk-measurement techniques based on statistical analyses such as stress-testing and back-testing.

## II. Hedge Fund Managers

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

In many jurisdictions, direct regulation of hedge fund managers involves registration with the home country regulatory authority. Registered managers are typically required to provide certain information to demonstrate that they have the appropriate resources; that they are able to manage conflicts of interest; and that their organisational structure is consistent with ensuring investor protection. Hedge fund managers may also be subject to prudential requirements.

Generally, registration with the relevant regulatory authority can be effective in addressing investor protection concerns. Such registration requirements provide comfort that the hedge fund manager is 'fit and proper' to manage client assets. However, the appropriateness of this approach is dependent on the extent to which investor protection is a genuine concern for hedge funds. Specifically, investments in hedge funds are usually confined to sophisticated and/or institutional investors who typically have sufficient expertise and/or operational capacity to ensure that their own interests are protected. It is likely that many hedge funds are not suitable investments to small or retail investors, who are traditionally the primary beneficiaries of investor protections.

Therefore, whilst registration requirements for hedge fund managers have noted benefits, authorities should give due consideration to the scope of such regulation. In practice, it is likely that investor protection concerns are best addressed by managers putting in place effective controls, including transparency policies and procedures, and separate business functions to minimize the potential for fraud or malpractice. To the extent that registration requirements can encourage managers to adopt such organisational structures, they can be effective in addressing these issues.

With regard to systemic risk, direct regulation of hedge fund managers is not likely to be as effective as 'indirect' regulation via prudential requirements on prime brokers and other bank lenders. As we have noted above, prime brokers are the primary source of leverage for hedge funds, and therefore act as the mechanism through which hedge fund risk is transmitted to the wider financial system. Effective regulation of these counterparties is therefore the most effective approach to mitigating systemic risk.

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

The CFA Institute Centre supports coordination, cooperation and sharing of information between supervisory authorities. We also support consistent, global, and enforceable self-regulation. This would help raise standards and improve the effectiveness of the regulatory approaches ultimately determined by the relevant authorities.

Moreover, we note that a convergence of approaches towards regulation of hedge fund managers in the largest markets, based on registration requirements, appears to be underway. We expect this to lead to a more consistent regulatory framework for hedge fund managers.

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

The Consultation notes that the IOSCO Task Force recommends that regulatory oversight should be risk-based, focusing on the systemically important hedge fund managers. The CFA Institute Centre supports regular risk-based oversight of large fund managers in combination with regular, if less-frequent oversight of all managers. By focusing regular review of those entities that are of systemic importance, the problem of 'too big to fail' (and the associated issue of 'moral hazard'), is addressed.

There are a number of factors that could be used to determine whether a fund manager (or underlying fund) is systemically important. For example, factors may include assets under management, degree of leverage employed, number of prime brokers, level of investment in illiquid assets, and so on. The communiqué from the recent meeting of the G-20<sup>11</sup> in London notes that the revamped Financial Stability Board, in conjunction with the International Monetary Fund, will work towards setting guidelines for determining systemic importance:

*"In order to prevent regulatory arbitrage, the IMF and the FSB will produce guidelines for national authorities to assess whether a financial institution, market, or an instrument is systemically important... These guidelines should focus on what institutions do rather than their legal form".*

We support these efforts.

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

The Consultation lists the following information that regulators may require from hedge fund managers for the registration process:

- background of management, personnel, organisation, and ownership;
- assets under management;
- business plan;
- services offered;
- hedge fund investors targeted;

<sup>11</sup> See [http://www.g20.org/Documents/Fin\\_Deps\\_Fin\\_Reg\\_Annex\\_020409 - 1615\\_final.pdf](http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409 - 1615_final.pdf)

- fees charged;
- investment-related affiliates;
- investment strategies utilised;
- risk tools or parameters employed;
- identification of key service providers, such as independent auditors, sub-advisers and administrators; and
- conflicts of interest.

The Consultation also notes that the minimum information required should be consistent across all firms; should provide adequate transparency into the business of the hedge fund manager, and; should be made available to all prospective clients prior to subscription. Additionally, this information would be made available to authorities in different jurisdictions and thus facilitate monitoring and inspection.

Should industry codes of conduct fail to sufficiently address the relevant issues in a manner that is consistent and enforceable, then the above registration requirements for hedge fund managers can be effective in ensuring substantive transparency policies toward investors, counterparties, and relevant regulators from hedge fund managers. Accordingly, we are broadly supportive of these recommendations, which should improve the transparency of hedge fund managers.

*Q: Do you agree with the proposed approach to ongoing supervision?*

The Consultation sets out the following factors for regulators to consider on an ongoing basis with regards to hedge fund managers:

- the existence of a comprehensive and independent risk management function;
- the existence of a strong independent compliance function;
- adherence to standardised valuation principles and independent verification of fund valuations;
- adequate segregation and protection of client assets;
- an independent audit on an annual basis;
- the extent of prudential requirements placed on the manager;
- adequate management and disclosure of conflicts of interest;
- strong governance mechanisms for remuneration structures and practices;
- transparency of fund information towards regulators; and
- proper disclosures towards investors.

Where hedge fund managers have demonstrated compliance with these provisions through adoption and application of a given code of conduct that is monitored by the relevant industry body, the extent of ongoing supervision should be adjusted to take effect of this. This would avoid over-lapping regulation and improve the efficiency of supervision.

**III. Hedge Funds**

*Q: 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?*

The Consultation notes that direct regulation at the level of the hedge fund could involve registration as well as on-going supervision of the fund. This would require the provision of certain information on the fund itself to the regulatory authority on a regular basis.

We recognise that regulatory authorities would likely gain greater insight into the holdings and strategies of hedge funds by obtaining certain fund data, such as periodic balance sheets/net asset value calculations in order to monitor risk exposures. It is likely that such information could be obtained most effectively from the hedge fund's financial counterparties (i.e. prime brokers and other bank lenders), since these entities are already subject to prudential supervision. Moreover, as we have commented throughout, effective supervision of prime brokers is likely the most effective approach to addressing the systemic risk concerns raised by hedge funds.

With regards to investor protection concerns, we see no additional benefit from direct regulation of the funds. As we have noted throughout, such concerns are best addressed at the level of the hedge fund manager, based on a combination of industry codes and registration requirements for the manager.

Therefore, in aggregate, we do not perceive direct regulation of hedge funds to be of significant marginal benefit.

#### IV. Industry Best Practice

*Q: 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?*

The Consultation notes that the IOSCO Task Force has encouraged the development of a consolidated set of industry best practice standards which should be globally consistent. It is also suggested that hedge funds fully adopt and adhere to such consolidated best practice standards and agree to a way in which regulators can monitor compliance with these standards.

In light of the issues set out in section 2 (namely, that adherence to industry codes is relatively low and inconsistently applied), the CFA Institute Centre supports the development and subsequent monitoring of a set of global best practice standards based on existing industry codes. We therefore urge industry bodies and participants to ensure that these recommendations are put into practice in a timely and verifiable fashion.

With regards to compliance monitoring of these standards, the Consultation suggests (in section 2 paragraph 90) that:

*"One possibility to enhance industry compliance with best practices would be to encourage the four separate groups [HFWG, PWG, MFA, AIMA] 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."*

We are very supportive of these recommendations and encourage IOSCO to incorporate and develop these suggestions into subsequent work streams.

#### V. Other

**Q: Do you have any comments on the proposals made?**

The recommendations set out in section V relate to focusing regulatory resources on systemically important hedge funds, adopting a risk-based approach, and encouraging further cooperation and exchange of information between regulators across all international jurisdictions (including offshore locations).

These recommendations are consistent with the outcomes from the recent London G-20 meeting, which asks the Financial Stability Board to develop mechanisms for cooperation and information sharing between relevant authorities.

We are supportive of these recommendations and have no further comments.

30<sup>th</sup> April 2009.