

# Hedge funds and U.K. regulation

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## Abstract

Hedge fund regulation in the U.K. may be viewed as three distinct issues: (1) Systemic risk issues, following the near-collapse of LTCM; (2) The regulation of hedge fund managers – many managers are established in the U.K.; and (3) Retail marketing. The position is complicated by the fact that the term 'hedge fund' is undefined and the funds themselves are not established in the U.K..

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## Hedge funds and U.K. regulation

The regulation of hedge funds, rather like the funds themselves, is a complex matter. This paper will explore the issue under three headings - (a) systemic risk issues; (b) the regulation of hedge fund managers, which is presently the U.K.'s closest involvement with hedge funds; and (c) the development of retail hedge funds.

### There are two important preparatory points to make:

- 1 The FSA does not regulate hedge funds established outside the U.K.. Regulation of the U.K. manager does not amount to regulation of the fund itself.
- 2 There is no universally accepted definition of a 'hedge fund'. Some commentators try to categorize hedge funds by reference to the strategies they operate<sup>2</sup>. In particular, new hedge fund strategies seem occasionally to be added to the list, suggesting that the definition is open-ended. There is some academic opinion<sup>3</sup> that investors are irrationally affected by an investment fund's name. This in turn could mean that the term 'hedge fund' is principally no more than a marketing tool, intending to group absolute return strategies so as to distinguish them from other types of funds.

### The FSA's statutory objectives

The FSA is established by the Financial Services and Markets Act 2000, which sets four statutory objectives for the regulator:

- **Maintaining market confidence** - Maintaining confidence in the financial system in the U.K..
- **Promoting public awareness** - In particular, this includes promoting awareness of the benefits and risks associated with different kinds of investment or other financial dealing and also the provision of appropriate information and advice.
- **Protecting consumers** - Securing the appropriate degree of protection for consumers. This must have regard to differing degrees of risk inherent in different investments, the differing degree of experience/expertise of different consumers, the needs consumers may have for advice and accurate information, and the general principle that consumers should take responsibility for their decisions.

- **Reducing financial crime** - Reducing the extent to which it is possible for financial crime to be carried on by a regulated person or in contravention of the general prohibition. The FSA must have regard to the desirability of regulated persons being aware of the risk of their business being used in connection with financial crime, taking appropriate measures to prevent financial crime, and devoting adequate resources to fighting financial crime.

The 'protecting consumers' objective requires a balance between protection and consumers having responsibility for their own actions. In a hedge fund context, this has particular relevance for retail marketing, which will be examined later in this article.

The Act also provides that the FSA must abide by a series of 'principles of good regulation':

- **Efficiency and economy** - This deals with the way the FSA uses its resources. When dealing with a specific risk, the FSA aims to select the regulatory tools which are most efficient and economic. The FSA has decided to go beyond the statutory obligation to consult regulated firms over the fees to be levied, and also consults on the FSA's budget as a whole.
- **The role of management** - This principle has two aspects to it<sup>4</sup>. Firstly, it means that the FSA must guard against being too intrusive into firms' affairs. In this interpretation, the FSA must, in effect, hold back and allow regulated firms to run themselves. Secondly, and as a consequence, it also means that the FSA must hold senior management responsible for risk management and controls within the firm.
- **Proportionality** - Restrictions applied to firms through FSA rules should be proportionate to the expected benefits for consumers and the industry. The FSA takes into account the costs incurred by firms and consumers. We are required by the Act to undertake and publish a cost benefit analysis of any proposed regulatory requirements<sup>6</sup>. An example of proportionality in action can be seen in the way in which the FSA regulates the wholesale and retail markets differently.

2 Indeed, the FSA did this in Discussion Paper 16, Hedge Funds and the FSA, see paragraph 3.2.

3 See P Raghavendra Rau et al, Changing names with style: Mutual fund name changes and their effects on fund flows, available on the Purdue University website: [www.purdue.edu](http://www.purdue.edu) (an unpublished working paper).

4 Section 2(3).

5 See A New Regulator for the New Millennium, Financial Services Authority, January 2000, page 10.

6 Section 155(2)(a) and (10).

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- **Innovation** - The FSA should facilitate innovation, e.g. by avoiding unreasonable barriers to entry or restrictions on existing market participants who launch new financial products and services.
- **International character of financial services and markets and the desirability of maintaining the competitive position of the U.K.** - The FSA will consider the impact on the U.K. markets and consumers of economic, industry, and regulatory situations overseas. The FSA must consider the international mobility of much financial services business. The FSA will co-operate with overseas regulators, to agree international standards and also to monitor global firms and markets effectively.

### Systemic risk issues

The systemic risk potential of hedge funds became apparent through the near-collapse of Long-Term Capital Management in August 1998. Long-Term Capital Portfolio LP (LTCM) was a hedge fund, established in Cayman in 1994. The fund itself was, therefore, a legal entity based outside the United Kingdom. The manager of the fund was Long-Term Capital Management LP, based in Connecticut. There was also an office of the manager in London. The management of LTCM was characterized by quality. Among the management were two Nobel laureates, Myron Scholes and Robert Merton, both of whom were enormously respected figures in the field of finance.

The perceived quality of the fund's management seemed to be borne out in the very high performance of the fund between 1995 and 1997. LTCM was engaged in convergence trades, the taking of offsetting positions in two related securities in the hope that the price gap between them would move in a favorable direction. However, LTCM was distinguished by its exceptionally large positions, at time assets exceeded U.S.\$ 125 billion, to which leverage in excess of 25 to 1 was added. Just before its near-collapse in August 1998, the fund held positions with gross notional amounts of U.S.\$ 1,400 billion made up of contracts on futures exchanges (U.S.\$ 500 billion), swaps contracts (U.S.\$ 750 billion), and options and other OTC

derivatives (U.S.\$ 150 billion). A number of the fund's futures positions represented more than 5% of the open interest in the contracts concerned and in some cases amounted to more than 10%. The fund had some very significant positions in individual securities.

LTCM's risks were crystallized by unusual market conditions following Russia's declaration of a Rouble devaluation and debt moratorium in August 1998. Investors suddenly sought to avoid risk and a flight to quality ensued.

'[LTCM] was betting that liquidity, credit and volatility spreads would narrow from historically high levels. When the spreads widened instead in markets across the world, LTCM found itself at the brink of insolvency. In retrospect it can be seen that LTCM and others underestimated the likelihood that liquidity, credit and volatility spreads would move in a similar fashion in markets across the world at the same time'<sup>7</sup>.

The fund's capital of U.S.\$ 4.8 billion at the start of 1998 fell to U.S.\$ 4.1 billion by July. In August alone, capital fell U.S.\$ 1.8 billion reducing the capital base to U.S.\$ 2.3 billion - a capital loss over the year to date of around 50%. Restructuring was essential, but reducing the individual positions was made very difficult because of their size.

In the event, the New York Federal Reserve Bank brokered a bail-out of the fund by its counterparties and creditors, who would have lost most had the fund collapsed. Investments totaling around U.S.\$ 3.6 billion were made into the fund. In this way, the responsibility and burden of resolving LTCM's difficulties remained with the counterparties that had allowed the fund to build up its positions in the first place. If the fund had collapsed, the repercussions may have spread far beyond the fund and its investors, counterparties, and creditors. The sudden liquidation of its positions could have led to significant moves in market values of positions held by other market participants.

<sup>7</sup> Report of the President's Working Group on Financial Markets, April 1999

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The President's Working Group observed that: '[LTCM's] positions, combined with market volatility and lack of liquidity might have led to a series of dramatic and punishing events for LTCM's trading counterparties and the markets themselves in the event of a default by the LTCM fund<sup>8</sup>.'

The experience of LTCM's counterparties led them to rethink the terms of their business with hedge funds. The FSA continues to monitor the situation.

### Regulation of hedge fund managers

#### General

Hedge fund managers tend to be relatively low risk according to the FSA's ARROW process, meaning that they represent relatively low risk to the FSA in its fulfillment of its statutory duties under the Financial Services and Markets Act.

Discussion Paper 16, Hedge Funds and the FSA, published by the FSA in August 2002, discussed the U.K. regulation of hedge fund managers in some detail. The principal question was whether the regulations applied to investment managers generally are applicable for hedge fund managers, or whether special rules are needed for hedge fund managers. Respondents suggested that the existing regime works adequately for hedge fund managers, and the FSA was inclined to agree<sup>9</sup>.

Some comment has been made from time to time that there are particular problems with fund managers managing hedge funds alongside other, 'conventional' funds, particularly in the conflicts of interest which this raises. For example, some have suggested that stock might be loaned from a 'conventional' fund to a hedge fund for the purpose of short selling it. In practice, a firm carrying out such a deal would frequently be faced with a problem of consistency of approach. If the fund manager is bearish on a particular stock, he would logically have the same opinion of the stock irrespective of the fund holding it. So stocklending from a conventional fund to a hedge fund would, absent special circumstances, be difficult to justify as logical. If the manager wishes to short sell a particular

stock for a hedge fund, his action would be consistent with selling it outright from his 'conventional' funds. A fund manager who could not justify a decision to lend stock for short selling purposes between two funds under his management may be in breach of the FSA's rules<sup>10</sup>. Importantly, issues concerning equality of treatment may also arise where two conventional funds are run together. So, although they may arise in a different or perhaps stronger way, where a hedge fund is involved, the existing rules should deal with situations where a fund manager does not treat one or other of his customers fairly.

Another point made to the FSA during the Discussion Paper 16 exercise concerned systems and controls. FSA rules already require that 'A firm must take reasonable care to establish and maintain such systems and controls as are appropriate to its business<sup>11</sup>'. Guidance to the rule gives greater detail on what a firm might consider as relevant in assessing its systems and controls<sup>12</sup>:

- The nature, scale, and complexity of its business.
- The diversity of its operations, including geographical diversity.
- The volume and size of its transactions.
- The degree of risk associated with each area of its operation.

A number of respondents to Discussion Paper 16 suggested that some hedge fund managers were seeking to manage their funds with less than adequate systems and controls. This would be a matter of concern and would, of course, amount to a breach of FSA rules. This is a matter which the FSA said it would consider further<sup>13</sup>.

#### Money laundering

The management of hedge funds is a particularly international business. Frequently the parties concerned with the fund are based in different jurisdictions. Thus the manager may be in the U.K., the administrator in Ireland, and the fund itself established in Cayman. It has been suggested that this inter-

<sup>8</sup> Ibid.

<sup>9</sup> Feedback Statement to Discussion Paper 16 (March 2003), paragraph 3.15.

<sup>10</sup> For example, Principles 1 (Integrity); 2 (Skill, care and diligence); 6 (Customers' interests); 8 (Conflicts of interest) and also COB 7.1 (Conflict of interest and material interest).

<sup>11</sup> SYSC 3.1.1R.

<sup>12</sup> SYSC 3.1.2G.

<sup>13</sup> Feedback Statement to Discussion Paper 16, paragraph 3.16.

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national structure means that hedge funds may therefore be particularly targeted by money launderers.

Hedge fund managers are rightly concerned to understand their duties to verify the identity of their funds' underlying investors. The FSA's Money Laundering Sourcebook provides that:

- 1 'A relevant firm must take reasonable steps to find out who its client is by obtaining sufficient evidence of the identity of any client who comes into contact with the relevant firm to be able to show that the client is who he claims to be.
- 2 If the client with whom a relevant firm has contact is, or appears to be, acting on behalf of another, the obligation in (1) is to obtain sufficient evidence of both their identities<sup>14</sup>.'

The client of the U.K. hedge fund manager will usually be the offshore fund itself. Verifying the identity of the fund itself is unlikely therefore to be a problem. There is some argument about whether, as a matter of law, a hedge fund acts 'on behalf of' its investors. Indeed, there may be a difference in effect depending on the legal nature of the hedge fund itself. If the hedge fund does invest on behalf of its investors an obligation arises under ML 3.1.3R(2) to verify the identities of the investors into the fund. The natural meaning of the words of ML 3.1.3R is to oblige the hedge fund manager to verify the identities of investors in the hedge fund.

The legal argument over whether or not hedge fund managers are technically liable to verify the identity of the fund's investors is not the end of the story. The Proceeds of Crime Act 2002 enacts a series of criminal offences. For example:

'A person commits a criminal offence if he enters into or becomes concerned in an arrangement which he knows or suspects facilitates (by whatever means) the acquisition, retention, use, or control of criminal property by or on behalf of another person<sup>15</sup>.'

These are serious offences, carrying a maximum penalty of fourteen years' imprisonment<sup>16</sup>. If appropriate disclosures are

made, the criminal offences are not committed. It is also an offence for a person to fail to disclose that he knows or suspects that another person is engaged in money laundering, where the knowledge or suspicion comes to the person 'in the course of a business in the regulated sector'<sup>17</sup>. Importantly, the offence is also committed where the person 'has reasonable grounds for knowing or suspecting', even if he does not, in fact, know or suspect<sup>18</sup>. The offence carries a maximum penalty of five years' imprisonment.

Clearly there is merit in performing verification checks to avoid the possible imputation of knowledge sufficient to ground criminal liability under the 2002 Act.

In reality, hedge fund managers may need to rely on their administrators to carry out verification checks. This does not absolve the manager of his own responsibilities under the FSA's Rules. Hedge fund managers will, therefore, need to decide what level of control or supervision to exert over the administrator.

### Retail hedge funds

#### Introduction

As mentioned above, the Financial Services and Markets Act sets statutory objectives for the FSA, including a requirement to secure an 'appropriate degree of protection for consumers'. In devising the protection, the FSA is required to have regard to, inter alia, 'the general principle that consumers should take responsibility for their decisions'. At present the U.K. retail market is not an easy place for hedge funds - their marketing is constrained. One argument put to us by the hedge fund industry is that consumer protection actually requires wider marketing of hedge funds. The industry points to the recent performance of widely marketable retail investment products in the bear market. Hedge funds, it is argued, provide a means for retail investors to make money or at least reduce their losses in periods of market downturn.

Discussion Paper 16 sought views on the desirability or otherwise of opening the retail market to hedge fund products.

<sup>14</sup> ML 3.1.3R.

<sup>15</sup> Proceeds of Crime Act 2002, section 328(1).

<sup>16</sup> Section 334(1).

<sup>17</sup> Section 330(3).

<sup>18</sup> Section 330(2).

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Respondents to the Paper did not demonstrate any particular desire to allow greater access to hedge fund products by retail investors. In addition, it is evident that allowing greater access by retail investors to hedge funds is a much broader question than might at first be thought. The term 'hedge fund' has no commonly accepted definition so the question, in the U.K. at least, becomes whether the retail regime should embrace a significant tranche of what are presently unregulated products. For these reasons, the FSA decided not to change the rules to allow for retail hedge fund products. However, our statutory objectives require the FSA in any event to keep the matter under review and the Feedback Statement said:

'...we recognize that the regulatory status of presently unregulated schemes needs to be kept under review. We will continue to discuss the possibility of a new approach with market participants. This new approach would allow for a broader range of funds to be brought into the regime for retail investment products<sup>19</sup>.

The question of greater retail hedge fund investment is likely to persist.

Greater retail marketing for hedge funds raises many issues, explored in greater detail below. These reinforce the fact that opening hedge funds to the retail market would be a significant step to take in the U.K., which can perhaps best be appreciated by looking at the issue through the eyes of the retail investor. The present range of widely marketable retail products does not carry as wide a range of risk and return possibilities as do unregulated funds, such as hedge funds. In short, it is much more likely that a hedge fund will collapse with a significant or total loss of capital than is the case with retail funds. In January 2003, for example, a Japanese Fund called 'Eifuku' collapsed spectacularly over a period of one week, despite calm trading conditions. There was no fraud alleged. The manager simply adopted the wrong strategy. Total loss is an unlikely contingency for U.K. retail funds, at least absent fraud. Opening the retail market to hedge fund related products, therefore, creates the prospect for mis-buying, mis-selling,

and misunderstanding on the part of retail investors and, indeed their intermediaries.

If the FSA were to consider allowing the wider marketing of hedge funds, the following matters, among others, would need to be considered:

- **Marketability** - The extent to which the products are to be marketable. If restrictions on marketing are to remain, questions arise as to how the investor base should be stratified. Internationally there are three methods of stratification - net worth of the investor, sophistication of the investor, and/or ability to meet a minimum investment threshold.
- **Investor eligibility** - It is possible to create rules to prevent the fund itself from accepting investors unless they meet certain criteria. Some party will, therefore, need to accept responsibility for ensuring that all investors in the fund reach the eligibility criteria.
- **Domicile of fund** - The extent to which hedge funds, as opposed to hedge fund manager, should be encouraged to establish in the U.K.. This would have taxation implications and so would not be solely an FSA matter.
- **Disclosure** - Requirements for investors to be provided with certain information.
- **Distribution** - Rules may need to be applied to the manner in which retail hedge funds are distributed. For example, rules may be applied to the selling process, or possibly responsibilities applied to the product provider to ensure that intermediaries are enabled to distribute the products competently.
- **Product regulation** - The extent to which the product structure or the operation of the fund should be subjected to regulation.

### Present position

The FSA's present approach to hedge funds is driven by the legal nature of the fund. If the fund is structured as a company, it can be marketed only in accordance with its relevant corporate structure. The FSA is not prepared, at the present time, to

<sup>19</sup> Feedback Statement to DPI6, Hedge Funds and the FSA, paragraph 4.15.

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admit single manager hedge funds to the Official List. Funds of hedge funds may be listed.

Where the fund is structured as a collective investment scheme, it would not satisfy the requirements for FSA authorization. The fund will, therefore, be marketable in accordance with the rules for unregulated collective investment schemes generally. These are set out in the FSA's Handbook<sup>20</sup>. In brief, unregulated collective investment schemes can be marketed to persons who are, or have recently been, participants in similar schemes, and persons for whom an authorized firm has taken reasonable steps to ensure that the investment is suitable<sup>21</sup>.

There are presently no rules applied to investor eligibility in hedge funds.

Hedge funds do not choose to domicile themselves in the U.K., essentially for tax reasons. There are requirements for disclosure by both companies and unregulated schemes (see COB 10 for schemes). Product regulation is not applied to unregulated schemes.

### Near future

In May 2003, the FSA published Consultation Paper 185, *The CIS Sourcebook - A New Approach*. CP185 suggests a substantial revision of the regime for authorized schemes. This includes the establishment of a new regime of authorized non-retail funds. Those products would enable the authorization of U.K. domiciled funds with significantly less product regulation than currently applies to authorized retail funds. Retail investors (with the exception of expert private customers) would not generally be eligible to invest, nor would they be open to have non-retail funds marketed to them.

The authorization by the FSA of hedge fund related products is an important step. This will enable the FSA to become much more familiar with the day-to-day operation of hedge fund related products.

### What about the long-term?

The Feedback Statement to DP16 made clear that the FSA would continue to monitor the situation as regards retail marketing of hedge funds. Some other European (and other) countries have recently been revisiting their regulatory approach to hedge fund products. Germany has recently announced a regime for wide marketability of funds of hedge funds for retail investors.

The key issue is investor understanding, or more specifically the scope for investors to mis-buy, have mis-sold to them, or to misunderstand the nature of complex products. The U.K. has been subject to several recent instances of mis-selling. If hedge fund products were to have greater marketability to retail investors, it would be important to ensure that they can avoid these problems.

The European Parliament recently debated a report 'on the future of Hedge Funds and Derivatives'. This report, and its contents for the establishment of a cross-border marketing regime for 'sophisticated alternative investment vehicles' ('SAIVs'), are discussed in this issue of the *Journal*. Interestingly, Mr. Purvis, the author of the study, has not proposed adding to the existing UCITS regime for cross-border fund marketing. This suggests that he recognizes that it is important for retail investors to understand whether any given product is a UCITS or a SAIV. In addition, Mr Purvis' report does not seek to define a 'hedge fund' - indeed he recognizes that there may be no grounds to discriminate against other types of 'alternative' investment vehicles in favor of 'hedge funds'.

The Report and debate will serve to inform the European Commission on its own approach to hedge funds and other alternative investment vehicles.

<sup>20</sup> COB 3, Annex 5.

<sup>21</sup> The person to whom the scheme is promoted must be an established or newly accepted customer of the firm or of a person in the same group as the firm.