Hedge Funds Oversight

Final Report

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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CONTENTS

EXECUTIVE SUMMARY

1. The IOSCO Technical Committee published its Consultation Report, entitled *Hedge Funds Oversight* on 18 March 2009 (the Consultation Report).[1] The purpose of the Consultation Report was 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 to make preliminary recommendations of possible principles and actions that may serve to mitigate these risks (Chapter 3).

2. The aim of this Final Report is to recommend the following six high level principles on the regulation of hedge funds, taking into account the outcome of the public consultation and the hearing held in Madrid on 20 April 2009:

   i. Hedge funds and/or hedge fund managers/advisers should be subject to mandatory registration.

   ii. Hedge fund managers/advisers which are required to register should also be subject to appropriate ongoing regulatory requirements relating to:

      a. Organisational and operational standards;

      b. Conflicts of interest and other conduct of business rules;

      c. Disclosure to investors; and

      d. Prudential regulation.

   iii. Prime Brokers and banks which provide funding to hedge funds should be subject to mandatory registration/regulation and supervision. They should have in place appropriate risk management systems and controls to monitor their counterparty credit risk exposures to hedge funds.

   iv. Hedge fund managers/advisers and prime brokers should provide to the relevant regulator information for systemic risk purposes (including the identification, analysis and mitigation of systemic risks).

   v. Regulators should encourage and take account of the development, implementation and convergence of industry good practices, where appropriate.

   vi. Regulators should have the authority to co-operate and share information, where appropriate, with each other, in order to facilitate efficient and effective oversight of globally active managers/advisers and/or funds and to help identify systemic risks, market integrity and other risks arising from the activities or exposures of hedge funds with a view to mitigating such risks across borders.

[1] Available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD288.pdf.

BACKGROUND

3. 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 24 November 2008[2] 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.

4. The Task Force was requested to examine issues surrounding unregulated financial entities. Given the G-20's particular interest in hedge funds, the Task Force decided to focus its work on hedge funds[3], rather than deal with other potentially 'unregulated' entities such as private equity funds (which have very recently been reviewed by IOSCO[4]) or Special Investment Vehicles (which could as easily be described as 'products' rather than 'entities'). However, many of the observations and conclusions described in the Consultation Report and in this Final Report may be applicable to other market participant entities that hold and/or control large pools of capital.

5. The IOSCO Technical Committee acknowledges in its Consultation Report that there is no consistent or agreed-upon 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;

   - often significant 'own' funds are invested by the manager[5];

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

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

3 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. In addition, in some countries the underlying funds themselves are subject to direct regulation.

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

5 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.

- more diverse risks or complex underlying products are involved[6].

6. 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.

7. The conclusions and recommendations of the Consultation Report were provided as input into the G-20 summit in April 2009.

8. The G20 favoured increasing regulatory oversight over hedge funds/hedge fund managers, as stated in its declaration of 2 April 2009:[7]

> "hedge funds or their managers will be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators, including on their leverage, necessary for assessment of the systemic risks that they pose individually or collectively. Where appropriate, registration should be subject to a minimum size. They will be subject to oversight to ensure that they have adequate risk management. We ask the FSB [Financial Stability Board] to develop mechanisms for cooperation and information sharing between relevant authorities in order to ensure that effective oversight is maintained where a fund is located in a different jurisdiction from the manager."

9. The IOSCO Technical Committee is aware of the European Commission's proposed Directive on Alternative Investment Fund Managers (AIFMs)[8] which has the objective of creating a comprehensive and effective regulatory and supervisory framework for AIFMs at the European level. Although there may be potential overlaps, the scope of this proposed Directive is broader than the scope of the work of the IOSCO Task Force. In the United States, the US Treasury Department has proposed the following approach with respect to hedge funds: required registration of all advisors to hedge funds whose assets under management exceed a certain threshold; mandatory requirements for disclosure to investors and counterparties and for regulatory reporting; regulatory reporting requirements regarding information necessary to determine whether any hedge funds could pose a systemic threat and should be subjected to prudential standards.[9] While it is anticipated that Congress will consider legislation in 2009 regarding these proposals, it is unclear what the ultimate regulation will be.

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6 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.

7 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." *See 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.

8 http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm.

9 See Testimony by U.S. Treasury Secretary Timothy Geithner to U.S. House Financial Services Committee (March 26, 2009) available at http://www.treas.gov/press/releases/tg71.htm.

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

11. For investor confidence to return to these funds and to the financial sector in which they operate, coordinated and consistent action is necessary, recognising that global economies are interconnected and financial instruments and investment vehicles are interdependent. Restoring investor confidence will require the application of common approaches to regulatory risks and co-operation across multiple jurisdictions and different financial instruments. In this respect, the IOSCO Technical Committee believes that the six high level principles on hedge funds regulation that it recommends in this Final Report will be essential in restoring investor confidence through improved investor protection and better detection and avoidance of systemic risks and other regulatory risks posed by hedge funds.

12. Despite these issues, the IOSCO Technical Committee in its Consultation Report and industry representatives in their responses to the consultation recognised the benefits hedge funds may provide to financial markets. Hedge funds can provide liquidity, price efficiency, and risk distribution, can contribute to the further global integration of financial markets and can offer diversification benefits. A balanced and measured approach to regulating hedge fund activity is therefore needed to ensure these benefits continue, while the risks noted above can be effectively mitigated.

THE SIX HIGH LEVEL PRINCIPLES ON THE REGULATION OF HEDGE FUNDS

Introduction

13. The Consultation Report discussed the regulatory issues presented by hedge funds. It focused on the recent financial crisis and issues around systemic risk but also touched on on-going regulatory concerns regarding hedge funds, including investor protection and market integrity issues and monitoring and investigating cross border activity.

14. Importantly, it recognised that the recent financial crisis is not actually a "hedge fund crisis".[10] Indeed many of the financial firms that failed or required governmental intervention were already subject to a high degree of regulatory oversight. However, the activities of hedge funds may have amplified the consequences of the crisis. This occurred, for instance, because of the need for hedge funds (along with many other market participants) to quickly unwind positions because of liquidity restrictions in meeting margin calls or significant requests for redemption by investors.

15. The IOSCO Technical Committee concluded that these risks arising from the role played by hedge funds in financial markets and other regulatory risks, as identified in Chapter 1 of the Consultation Report, need to be appropriately addressed through global action.

16. Despite the existing regulatory standards and principles published by regulators and standard setters which are outlined in Chapter 2 of the Consultation Report, questions continue to be asked about (a) how effective existing regulatory standards and domestic regimes are and (b) how well these have been implemented in practice.

17. Questions have also been raised regarding whether, and to what extent, it is appropriate to rely on existing industry led initiatives to develop codes of good/best practice. Even if the coverage of such standards, coupled with the official sector recommendations, is quite broad, open questions remain as to the effectiveness of such standards. This is primarily because:

    - the number of hedge fund managers adopting the different standards varies and adoption of some of the standards remains relatively low;

    - there are a number of different industry standards in force that cover a range of various issues;

    - regulatory standards differ between jurisdictions; there are still open questions regarding the enforceability of such codes either by regulators or industry associations.

18. It is very important to emphasise, as recognised by some industry members in their responses, that any regulatory measures or standards need strong collective global action and application – as the hedge fund industry is highly global and mobile.

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[10] In the United States, Congress passed a bill establishing the Financial Crisis Inquiry Commission to examine the causes of the current U.S. financial and economic crisis, taking into account fraud and abuse in the financial sector and other specified factors. See Fraud Enforcement and Recovery Act of 2009, Pub.L. 111-21, 123 Stat. 1617, S. 386.

19. Having considered the public comments received on the Consultation Report, the IOSCO Technical Committee has developed the six high level principles below which should be applied to the regulation of hedge funds. These principles should enable regulators to address, in a collective and effective way, the regulatory (including investor protection) and systemic risk posed by hedge funds. It is envisaged that this can be achieved, for instance by either strengthening the existing standards and practices comprising national regulatory regimes and/or by introducing additional requirements.

20. Some recommendations are not in the IOSCO remit to deliver in isolation but will need support from banking standard setters (Basel Committee on Banking Supervision) and other regulators. There is also a general need to strengthen regulatory resources and expertise in the area of hedge fund regulation and improved information sharing by, and amongst, regulators.

The Six Principles

21. Regulatory regimes currently operate through a combination of:

    - direct registration/authorisation and monitoring/supervision of hedge funds and/or hedge fund managers; and

    - regulation of hedge fund counterparties (such as banks).

22. As noted above, regulatory regimes are not consistent across the globe and so in this Final Report, the IOSCO Technical Committee agrees that the regulation of hedge funds should be focused mainly on the following six high level principles:

    i. Hedge funds and/or hedge fund managers/advisers should be subject to mandatory registration.

    ii. Hedge fund managers/advisers which are required to register should also be subject to appropriate ongoing regulatory requirements relating to:

        a. Organisational and operational standards;

        b. Conflicts of interest and other conduct of business rules;

        c. Disclosure to investors; and

        d. Prudential regulation.

    iii. Prime Brokers and banks which provide funding to hedge funds should be subject to mandatory registration/regulation and supervision. They should have in place appropriate risk management systems and controls to monitor their counterparty credit risk exposures to hedge funds.

    iv. Hedge fund managers/advisers and prime brokers should provide to the relevant regulator information for systemic risk purposes (including the identification, analysis and mitigation of systemic risks).

    v. Regulators should encourage and take account of the development, implementation and convergence of industry good practices, where appropriate.

vi. Regulators should have the authority to co-operate and share information, where appropriate, with each other, in order to facilitate efficient and effective oversight of globally active managers/advisers and/or funds and to help identify systemic risks, market integrity and other risks arising from the activities or exposures of hedge funds with a view to mitigating such risks across borders.

(i) Hedge funds and/or hedge fund managers/advisers should be subject to mandatory registration

23. 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.

24. Regulatory requirements for hedge fund managers, applied in a number of jurisdictions, are in most cases in line with the guidelines included in the FSB recommendations, originally addressed to the private sector and already widely accepted.[11] The upgrading of such guidelines as described below to officially supported regulatory principles would help to address the potential risks identified in Chapter 1 of the Consultation Report.

25. Some IOSCO Technical Committee members would favour the introduction of regulatory requirements at the level of the funds themselves to facilitate obtaining fund specific information and to get an overall picture of the risks posed by the funds. 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. Whether this additional layer of regulation is required to address systemic and market integrity risks will reflect local conditions and industry structure.

26. A variety of approaches to regulation are possible, but the important point to note is that the regulatory system should set standards for the authorisation/registration and the regulation of those who wish to operate hedge funds (managers/advisers) (and/or – where relevant - for the registration of the fund).

27. In addition, the IOSCO Technical Committee recommends that regulatory oversight should be risk-based and proportional and, so, should be more focused on systemically important and/or higher risk hedge fund managers. A *de-minimis* cut-off is one of the approaches which has been suggested. A possible cut-off could be determined taking into account certain characteristics such as leverage, economic exposure etc. Another possibility, which takes into account the principle of proportionality, is to require the registration of all hedge fund managers but consider a lower level of ongoing supervision for managers below a certain *de-minimis* cut-off.

28. The relevant regulatory requirements should allow the regulator at the level of the funds themselves to get an overall picture of the risks posed by the hedge funds.

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[11] Please see Annex 2 of the IOSCO Consultation Report, *Hedge Funds Oversight*, 18 March 2009 available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD288.pdf

29. The type of information that could be considered as possible requirements, at registration/authorisation of the manager/advisor, includes:

- background of key management and investment personnel, organisation and ownership;
- assets under management, including leverage, concentration and liquidity metrics;
- business plan;
- services offered;
- hedge fund investors targeted;
- fees charged;
- investment related affiliates;
- investment strategies utilised;
- risk tools or parameters employed;
- identification of key service providers, such as independent auditors, sub-advisers, administrators, custodians, prime brokers and credit providers;
- delegation and outsourcing arrangements; and
- conflicts of interest and procedures to identify and address them.

30. The information supplied through the registration/authorisation process would provide adequate transparency into the business of the hedge fund manager/advisor and/or on the funds managed and would help regulators (individually and co-operating across borders) to identify, analyse and mitigate possible systemic risks. Such information could also be made available to all prospective investors prior to the execution of a subscription agreement or other investment management agreement.

(ii) Hedge fund managers/advisers which are required to register should also be subject to appropriate ongoing regulatory requirements, relating to:

a. Organisational and operational standards

31. The regulatory system should set (in view of the risk posed) standards for internal organisation and operational conduct to be observed on an ***ongoing basis***, by hedge fund managers/advisers[12] which should take into account at least the following:

- a comprehensive risk management framework supported by an independent risk management function, appropriate to the size, complexity and risk profile of the

[12] 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.

hedge fund manager. The framework should consider risks across the whole of the hedge fund managers' business, including: market, liquidity, credit and operational risks (including also stringent stress testing of their positions). In practice, one would expect the manager to regularly measure, monitor and manage risk, including stress testing of portfolios for market and liquidity risk. Appropriate disclosure regarding risk should also be made to investors;

- a strong and independent compliance function appropriate to the size, complexity and risk profile of the hedge fund manager supported by sound and controlled operations and infrastructure, adequate resources and checks and balances in operations;

- the nine IOSCO principles on valuation remain valid[13]. 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;[14]

- adequate segregation and protection of client monies and assets through use of custodians and depositories that are, in appropriate circumstances, independent, and ensure investors' funds are protected;

- hedge fund managers (and where appropriate funds themselves), like other market participants, should maintain appropriate records of the trades performed on behalf of the fund. Such information should be available to the regulators upon request e.g. for market abuse inspections; and

- the business accounts (including trading records of the fund manager and/or of each of the funds managed) should be subject to independent audit on an annual basis.

b. Conflicts of interest and other conduct of business rules

32. Hedge Fund managers like other fund managers are subject to significant conflicts of interest (institutional and personal).[15] They need to manage such conflicts and provide full disclosure and transparency about such conflicts of interest and how they manage

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13 *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

14 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").

15 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.

them.

33. Compensation/remuneration structures and practices need to be subject to strong governance mechanisms and to manage conflict of interest issues (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 FSB in its work stream on remuneration as appropriate.

c. Disclosure to investors

34. The regulatory system should provide for proper disclosure to investors.

35. Hedge fund managers/advisers or the fund 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.

36. As part of these ongoing requirements, regulators should have the power to access and inspect the fund managers/adviser and their records and/or the funds.

d. Prudential regulation

37. Some members of the IOSCO Technical Committee believe that adequate capital requirements are important to ensure that hedge fund managers 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 those required of firms with similar business profiles. Therefore, hedge fund managers should be subject to prudential requirements that reflect the risks they take (and which are most likely to be akin to other asset manager requirements), e.g. operational risk, client money, etc.

38. Not all IOSCO members are prudential regulators. The IOSCO Technical Committee recommends that further work should be undertaken with other standard setters and regulators to further develop this principle at a global level. The IOSCO Technical Committee also notes that there may be a need in some jurisdictions to review domestic arrangements for information-sharing, coordination of regulatory standards and approaches in this area.

(iii) Prime Brokers and banks which provide funding to hedge funds should be subject to mandatory registration/regulation and supervision. They should have in place appropriate risk management systems and controls to monitor their counterparty credit risk exposures to hedge funds

39. Prime brokers and banks, which provide funding and other services to hedge funds, are subject to both conduct and prudential regulation in all jurisdictions. These institutions can be the main transmission mechanism through which the significant distress or failure of a single fund or cluster of funds may result in systemic effects, and potentially impact on the real economy. This may result through a curtailing of the provision of credit or disruptions to payment and clearing services, which could then impact directly on the real economy.

40. The IOSCO Technical Committee supports the earlier recommendations adopted by the FSB which focused on systemic risks and market dynamics concerns raised by highly

leveraged institutions,[16] supplemented in many cases by standards issued by the sectoral standard setters (in certain cases these are in the process of being updated).

41. The IOSCO Technical Committee recommends that these counterparties should have strong risk management controls over their exposures to hedge funds and an ability to obtain information from hedge funds to engage in effective risk management. A lack of transparency combined with poor systems and controls can make counterparty risk more difficult to assess and thus increase the risk of funds impacting more widely on the financial system.

42. Securities regulators should be able to obtain – if necessary through working with other regulators – non-public reporting of information on the prime brokers' and banks' most systemically significant and/or higher risk hedge fund counterparties, as explained in principle (iv) below.

(iv) Hedge fund managers/advisers and prime brokers should provide to the relevant regulator information for systemic risk purposes (including the identification, analysis and mitigation of systemic risks)

43. ***Prime brokers/banks*** should provide on-going information on hedge funds to their regulators (where necessary this should be shared amongst domestic regulators). The main objectives of this information gathering through prime brokers/banks are to gauge risk appetite (funds and banks), identify the emergence of large and highly leveraged funds, to assess banks ability to aggregate counterparty exposure across business lines (a post-LTCM recommendation), and to build a prime brokerage "soft network".

44. As a result, regulatory authorities should require prime brokers/banks operating in their markets to provide the following information on a regular basis:

- credit exposures to hedge funds (largely OTC derivatives and secured lending);
- the aggregate and their largest current exposures (mark to market), unsecured (current exposure less the monetisable value of the collateral);
- potential exposures (the estimated maximum counterparty exposure expected to occur at a future date with a specified degree of statistical confidence). The largest exposures are selected by current and potential exposures and sorted by cash loaned and by margin requirement, and show the names of the hedge funds, the management company and the fund strategy;
- market or product concentrations on an individual or aggregate fund basis;
- hedge fund managers with significant proportion of the daily liquidity/volume of important markets;
- prime broker/banks's aggregate margin requirement;
- cash loaned;

[16] FSF Report of the Working Group on Highly Leveraged Institutions, 5 April 2000, available at http://www.financialstabilityboard.org/publications/r_0004a.htm.

- value of long and short positions; and
- net equity.

45. ***Hedge Fund managers/advisers*** should provide to their regulators information about the funds in their portfolio, including, for example, the information outlined in paragraph 29.

46. In addition, hedge fund managers should provide to regulators appropriate information on an on-going basis, for example:

    - information on their prime brokers, custodian, and background information on the persons managing the assets;
    - information on the hedge fund manager's larger funds including, the net asset value, predominant strategy/ regional focus and performance;
    - leverage and risk, including concentration risk of the hedge fund manager's larger funds;
    - assets and liability information for the hedge fund manager's larger funds;
    - counterparty risk, including the biggest sources of credit;
    - product exposure for all of the hedge fund manager assets e.g. equities, structured/securitised credit, investment grade corporate bonds etc; and
    - identification of investment activity known to represent a significant proportion (in terms of liquidity/volume) of such activity in important markets or products.

47. 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.

48. This information gathering would help regulators to identify current or potential sources of systemic risk that hedge funds may pose, either individually or collectively and consequently help regulators in better understanding:

    - the leverage used in different strategies and the size of funds' "footprints";
    - the scale of any asset/liability mismatch;
    - substantial market or product concentration and liquidity issues; and
    - hedge fund counterparty risks.

49. Hedge fund managers/advisers must be able to obtain all the necessary information from the funds they manage – irrespective of location of those funds – so that hedge fund managers are able to effectively evaluate the risks they are taking in their portfolio.

(v) Regulators should encourage and take account of the development, implementation and convergence of industry good practices, where appropriate

50. The development of a common set of industry standards remains of high value to all market participants including securities regulators, active market participants and investors.

51. The IOSCO Technical Committee will work with industry bodies to develop a consolidated set of industry standards which should reflect and supplement the above recommendations and should be globally consistent.

52. Regulators should encourage hedge funds/hedge fund managers to adhere to the consolidated set of industry standards and may take into account those standards in giving effect to the above principles. Regulators should also agree to a way in which they could be informed about the take up/compliance (and consequences of non compliance) by individual hedge funds/hedge fund managers of/with the standards.

(vi) Regulators should have the authority to co-operate and share information, where appropriate, with each other, in order to facilitate efficient and effective oversight of globally active managers/advisers and/or funds and to help identify systemic risks, market integrity and other risks arising from the activities or exposures of hedge funds with a view to mitigating such risks across borders

53. The IOSCO Technical Committee believes that national regulators should allocate resources to the supervision of systemically important hedge funds/hedge fund managers in a risk based manner, enhance their understanding of the sector, including individual institutions, and support greater cooperation and information exchange among regulators where appropriate. Any additional data and information provided by hedge funds/hedge fund managers/counterparties needs to be properly evaluated by the regulators. This requires both know-how and resources. Regulatory oversight does not prevent hedge fund failures and is no substitute for strong risk management by all market participants.

54. Subject to appropriate confidentiality safeguards and national law restrictions, the IOSCO Technical Committee believes that - from the point of view of supervision and enforcement - securities regulators should have the authority to:

- collect where necessary relevant information from managers/advisers and/or funds (and through cooperation with other regulators from hedge fund counterparties) also on behalf of a foreign regulator;

- exchange information on a timely and on-going basis, as deemed appropriate, with other relevant regulators on internationally active funds that may pose systemic or other significant risks;

- perform where appropriate joint inspections, including on-site inspections; and

- enforce against wrongdoers and assist foreign regulators in enforcement.

55. With respect to investigations and enforcement proceedings, the exchange of information should be based on the principles established in the IOSCO Multilateral Memorandum of Understanding and the ongoing work of the Technical Committee Standing Committee on Enforcement and the Exchange of Information. With respect to the exchange of non-public supervisory information, the IOSCO Technical Committee

should consider the development of appropriate principles.

56. The IOSCO Technical Committee recommends that all securities regulators - including those in offshore centers - should apply the above mentioned recommendations and ensure that appropriate information about the funds and their activities is maintained and properly audited for each fund registered in their jurisdiction.

57. The IOSCO Technical Committee believes that the question of non-cooperative jurisdictions is not specific to hedge funds. However, it highlights that it is paramount that, as regards inter alia hedge funds, regulatory cooperation between all jurisdictions covers all relevant regulatory areas. The IOSCO Technical Committee fully supports the G20 recommendations[17] in that respect.

[17] Please see in this respect the following Communiqués from the 2 April 2009 London Summit: Global Plan for Recovery and Reform, available at http://www.g20.org/Documents/final-communique.pdf and, in particular, the Declaration on strengthening the financial system, available at http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf.

ANNEX 1

FEEDBACK STATEMENT ON THE PUBLIC COMMENTS RECEIVED ON THE CONSULTATION REPORT ON HEDGE FUNDS OVERSIGHT

BACKGROUND

This Feedback Statement considers the main comments to the Consultation Report on "Hedge Funds Oversight" which the IOSCO Technical Committee published in March 2009.

The Consultation Report describes the operating environment of hedge funds, highlighting the associated regulatory risks (Chapter 1), reviews and illustrates the work and recommendations issued by IOSCO and other international organizations and regulators in this area (Chapter 2) and makes recommendations of possible principles and actions that may serve to mitigate these risks (Chapter 3).

The deadline for comments was April 30, 2009. IOSCO received 23 responses: 3 from Regulators, 1 from an Exchange and the others from Industry representatives (see Annex 2).

GENERAL COMMENTS

Overall, several respondents recognised that:

- Even though single hedge funds may not be systemically important, the hedge fund sector as a whole should be recognised as being of systemic relevance. In the light of the above, most of the respondents welcomed the proposal of having a mixture of direct and indirect regulation, in so far as a proportionate approach is endorsed in a view of avoiding over-regulation;

- It should be better stressed that hedge funds play an important role in the financial sector and were not the cause of the current crisis;

- Regulatory action should not be focused on hedge funds only, but all financial unregulated entities should rather be tackled;

- Future action should take into account the distinction between hedge funds domiciled in jurisdiction ensuring transparency and ongoing supervision and those domiciled in places where regulations are lax and concentrate its efforts on less transparent hedge funds;

- Although the primary targeted hedge fund investors are institutional or otherwise sophisticated investors having the ability to take informed decisions, hedge funds have became increasingly accessible to retail investors by means of funds of hedge funds or allocation of traditional funds assets in hedge funds. In this context, transparency of hedge funds towards investors is a challenge that needs further efforts;

- Considering the international dimension of hedge funds activities, cooperation between authorities and regulatory convergence should be encouraged.

1) Do you believe that the FSF (Financial Stability Forum) work will sufficiently cover the remuneration/ compensation issues / risks?

Almost all respondents stressed that the remuneration/compensation issues/risks are not hedge fund specific but affect the entire financial system and welcomed the FSF (recently renamed as Financial Stability Board (FSB)) work on sound compensation practice in the overall financial industry.

The majority of the respondents also noted that the compensation structure for hedge fund managers already aligns the interests of managers and investors, mitigating the relevant conflicts and provided elements supporting this position. On this basis, the issue of remuneration and compensation of hedge fund managers should not be overstated. See, e.g., *HFSB Public Response to the IOSCO Consultation Report on Hedge Fund Oversight*.

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

Whilst several respondents recognised that the Consultation Report provides a comprehensive description of many of the regulatory risks posed by hedge funds, others stressed the need for more empirical evidences. See, e.g., *AIMA, The Association of Investment Companies and IBFed's Public Responses to the IOSCO Consultation Report on Hedge Fund Oversight.*

Regarding the specific risks, some respondents expressed the following views: (i) hedge funds use of leverage is substantially less than the leverage of other financial institution; (ii) the primary investors targeted by hedge funds are sophisticated and have the ability to request and obtain the necessary information to take an informed investment decision; (iii) it is important to focus more on the risks that counterparties can pose to hedge funds. See, e.g., *Managed Funds Association's Public Response to the IOSCO Consultation Report on Hedge Funds Oversight*.

Many respondents stressed the fact that hedge funds were not the cause of the current financial crisis and that hedge funds play an important role in the financial system.

3) 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?

Almost all respondents agreed that regulators should obtain information from prime brokers and banks on their hedge fund counterparties and fully supported strong risk management controls at regulated hedge fund counterparties. See, e.g., *Swiss Funds Association's Public Response to the IOSCO Consultation Report on Hedge Funds Oversight*. Some of them provided specific proposals on how systemic risks could be reduced e.g. by limiting commingling of the fund's assets with the prime broker's assets.

Some respondents also expressed the concern that hedge funds could have several counterparties and therefore the picture that regulators would receive could not be comprehensive. Accordingly, information from counterparties should be supplemented with information from hedge fund managers. One respondent stated that it makes more sense getting information directly from hedge funds and hedge fund managers.

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

All respondents broadly supported the proposal of having some form of direct regulation. In this respect, the majority of respondents favoured the alternative of directly regulating hedge fund managers, rather than the hedge fund themselves.

Nonetheless, some respondents pointed out that the direct regulation of hedge fund managers could not be enough from an investor protection perspective, considering that several hedge funds are established in offshore centres and retail investors are increasingly exposed to them. See, e.g., *Association Francaise De La Gestion (AFG)'s Public Response to the IOSCO Consultation Report on Hedge Funds Oversight*. According to these respondents, direct regulation of hedge fund managers should be supplemented with an appropriate and proportionate regulation of the hedge funds themselves.

In general, many respondents supporting indirect regulation also recognised that such an approach may not be sufficient and believe that the information provided by counterparties should be supplemented with information from hedge fund managers.

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

Considering the international dimension of the hedge funds activities, all respondents supported the need for more convergence on the regulation of hedge fund managers in order to minimise the risk of regulatory arbitrage and ensure better level playing field. See, e.g., *International Council of Securities Associations' Public Response to the IOSCO Consultation Report on Hedge Funds Oversight*.

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

All respondents agreed that regulatory oversight should be risk-based, but stressed the difficulty to determine ex-ante when hedge funds and their managers should be considered systemically relevant. See, e.g., *Malta Financial Services Authority's Public Response to the IOSCO Consultation Report on Hedge Funds Oversight*.

Broadly speaking, the following factors were suggested by certain respondents in order to consider the systemic relevance of the funds and relevant managers:

- fund size;

- investment strategies;
- level of leverage;
- number of prime brokers;
- concentration and liquidity of investments; and
- quality of risk management systems.

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

Although the large majority of the respondents broadly agreed with the proposed list of information to be provided by hedge fund managers at authorisation/registration, some respondents expressed different views in relation to the type or the focus of such information. Several respondents suggested to complement the proposed list with certain additional information, including adequate transparency on prime brokers and the implications of the domicile of the relevant fund, disclosure of leverage, concentration and liquidity metrics, delegation arrangements and measures to mitigate potential conflicts or, at least, to reduce their detrimental effect on investors. See, e.g., *CFA Institute's Public Response to the IOSCO Consultation Report on Hedge Funds Oversight*. One respondent challenged that the wider publication of details on business plan and fees charged could create commercial problems for the managers.

8) Do you agree with the proposed approach to ongoing supervision?

Many respondents broadly agreed with the proposed approach to ongoing supervision. See, e.g., *Bundesverband Alternative Investments e.V. (BAI) Public Response to the IOSCO Consultation Report on Hedge Funds Oversight*. Some comments stress the need to adopt a graduated and flexible approach in the case of smaller managers which are not considered to be of systemic relevance.

All respondents supported the requirement for an independent risk management and compliance functions. According to some respondents, for smaller managers this requirement may not be feasible or it would be appropriate to outsource part of these functions to a specialised third party service provider or the fund's administrator.

Regarding segregation of investment management functions and safekeeping/custodial functions, many respondents stated that it should always be required, regardless of the size of the institution. The majority of the respondents supported the approach proposed by IOSCO specifying that the independence of the custodian could be addressed through appropriate disclosure to investors of any affiliate or similar relationships between the fund's administrator and the custodian or independent third party administrators.

The proposed regulatory requirement of a robust and independent verification of the fund valuations was broadly shared by the respondents, although some comments expressed concerns related to the difficulty to value unquoted assets and to the length of time it could take to undertake an accurate independent assessment.

Some respondents did not agree with the proposal to request hedge fund managers to comply with minimum capital requirements considering that they are not depositary institutions and target sophisticated investors who understand the risks involved with their investments. See, e.g., *CompliGlobe's Public Response to the IOSCO Consultation Report on Hedge Funds Oversight*.

The respondents encouraged the development of rules dealing with management and disclosure of conflicts of interest.

9) 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 majority of the respondents did not favour direct regulation of hedge funds, assuming that access to these products is effectively restricted to institutional or otherwise sophisticated investors. See, e.g., *National Futures Association's Public Response to the IOSCO Consultation Report on Hedge Funds Oversight*.

Other respondents pointed out that infiltration of the retail market by hedge funds cannot be avoided and the higher legal risks related to offshore-domiciled funds cannot be neglected. Therefore, from an investor protection perspective, some respondents expressed the need for a mix of regulation both on managers and on the funds themselves, also differentiating between onshore-domiciled funds and offshore-domiciled funds. See, e.g., *Association Francaise De La Gestion (AFG)'s Public Response to the IOSCO Consultation Report on Hedge Funds Oversight.*

For some respondents, regulation of hedge funds should not confine the flexibility of hedge funds in terms of investment strategies or eligible assets, but introduce minimum standards at international level as regards e.g. the relationship with the fund manager and prime broker, custody of assets, distribution terms and transparency towards investors.

10) 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?

All the respondents agreed that IOSCO, also in coordination with FSF/FSB, should support the development of globally consistent industry best practice standards.

Some respondents, considering the disappointing results in terms of practical compliance with the existing codes, believe that standards cannot substitute legislation and an appropriate balance between legislation and professional codes should be achieved. See, e.g., *Austrian Alternative Investment Association's (VAI) Public Response to the IOSCO Consultation*

Report on Hedge Funds Oversight. In order to encourage and increase compliance with standards, some respondents also suggested to adopt a "comply or explain" approach together with peer pressure or self-regulation.

11) Do you have any comments on the proposals made?

In providing comments on the proposals made, the respondents shared the view that international regulatory cooperation and exchange of information between all jurisdictions (including offshore locations) are of great importance.

CONCLUSIONS IN LIGHT OF THE REVIEW OF THE RESPONSES

Many comments received by the respondents are broadly consistent with the approaches endorsed in the Final Report (the Report).

In line with the position expressed by the majority of the contributions, the Report recommends a balanced mixture of indirect and direct regulation of the hedge funds and/or their managers/advisers, consistent with the principle of proportionality and a risk-based approach. This regulatory option is also consistent with the G-30 recommendations and the last G-20 declarations, where it is recognised that hedge funds or their managers should be subject to registration and ongoing supervision.

Some specific proposals have been opportunely incorporated into the Report, including more detailed references to the systemic impact of counterparties and an integration of the list of information to be provided to the regulator at authorisation/registration. Moreover, the Report recognises that many of the conclusions and observations may be applicable to other under-regulated entities that control large pools of capital.

The section concerning international cooperation and regulatory convergence reflects the call for more level playing field and consistent worldwide supervision.

However, it should be considered that the views and concerns expressed in the responses were often divergent. Therefore, the IOSCO Technical Committee has agreed that some proposals received were not to be taken forward. In particular, those contributions strongly against registration/authorisation and prudential regulation of hedge funds/ managers appear to be in contrast with the guidance clearly provided by the G-20 and G-30 ministers. Similarly, the need to ensure that compensation structures are subject to strong governance has been recommended by the FSB and cannot be overlooked.

ANNEX 2

LIST OF RESPONDENTS TO THE CONSULTATION REPORT ON HEDGE FUNDS OVERSIGHT

- **Regulators**

Jersey Financial Services Commission

Malta Financial Services Authority

Cayman Islands Monetary Authority

- **Exchanges**

London Stock Exchange – LSE (UK)

- **Industry representatives**

Alternative Investment Management Association - AIMA

Association Française de la Gestion financière – AFG (France)

Association of Investment Companies – AIC

Austrian Alternative Investment Association – VAI (Austria)

Bundesverband Alternative Investments e. V. – BAI (Germany)

Bundesverband Investment und Asset Management e.V. – BVI (Germany)

Hedge Fund Standards Board – HFSB

CFA Institute Centre for Financial Market Integrity

CompliGlobe Ltd

EuropeanIssuers[18]

International Banking Federation (IBFed)

International Council of Securities Associations – ICSA

[18] EuropeanIssuers have not responded directly to the IOSCO Consultation Report but have provided the IOSCO Technical Committee with a copy of their response to the European Commission to its Consultation Paper on Hedge Funds.

Irish Funds Industry Association – IFIA (Ireland)

Managed Fund Association – MFA

National Future Association – NFA (USA)

Securities Industry and Financial Markets Association – SIFMA

Spanish Association of Collective Investment Schemes and Pension Funds – IVERCO (Spain)

Swiss Funds Association – SFA (Switzerland)

ANNEX 3
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