



26 Oct. 07 - [www.opalesque.com](http://www.opalesque.com)

## **Opalesque Exclusive: Voluntary hedge fund monitoring, U.S. and U.K. – a lawyer approves**

From Benedicte Gravrand, Geneva: Hedge fund self-regulation is the current trend to watch for, both in the U.K. and the U.S., and soon elsewhere. Mr. Mark Palmer, financial attorney at the international law firm Bracewell & Giuliani LLP (website) supports this trend and gave his reasons for doing so to Opalesque.

### **A logical step**

As hedge funds are becoming important players in the world's financial markets, so is their impact on the markets' stability: crisis such as LTCM or Amaranth can ruffle the financial systems seriously. Their edge with other financial products lies in their lack of regulations and their freedom to keep their investment strategies private, which entails lack of transparency. Regulators and investors have been requiring more of that for quite a while and this year, the SEC, as well as the German finance ministry, have attempted to stamp down but failed for practical reasons. Self-regulatory groups were then set up, this summer in the U.K., and more recently in the U.S. Following suit, the G7 industrial states expect the hedge funds industry to implement its own code of conduct from next year, Financial Times Deutschland said last week.

### **For and against**

Do hedge funds need regulations? If not, do they need self-regulations to improve disclosure and investor confidence? Some have argued that hedge funds cannot do business with transparency. "Asking a hedge fund to reveal its strategy, as the voluntary code does, is like asking Coca-Cola to reveal its formula, or Microsoft to give up its code" said an article in the IHT (source). Some might even say that hedge funds devising their own code of conduct might be self serving. And some members of the industry approve. A few days ago, RAB's founder Mr. Richard said to the Telegraph he was all in favour of self regulation: "We have always operated our funds in a clear and open manner. We have nothing to fear from greater regulation. We are a plain vanilla firm." (source).

### **Those who disapprove of self-regulations and why**

"There are people who think it is not enough for two reasons," said Mr. Palmer.

"There is a group who would like to regulate funds to adjust their behaviour because their approach is too short-term or too aggressive. That group, I think, will never be satisfied with any self-regulation. They are looking to impose substantive restrictions on investment strategies. That approach to regulating the financial markets is really ridiculous for a number of reasons: who knows whether short term or long term is the right strategy? If the troops are storming a beach, a short-term approach is usually a good idea ... Regulators who are trying to enforce 'long-term' investment approach on the funds will get nowhere because there is no way to define that; also it is just a protection for people who feel threatened by it without any real justification. What it belies is a lack of faith in the market on the fundamental level. That is a failed strategy.

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Another group of people view self-regulations as self-serving, that the large funds will set standards that are designed to benefit themselves, thereby disadvantaging investors or small funds or people who have a more entrepreneurial approach. I think that is a legitimate concern. Anytime a body gets together to develop standards, there are always anti-competitive implications. But it is not a reason to ignore self-regulations.”

### **Why is it a good idea?**

Mr. Palmer continued: “My argument would be this: first, we really don’t have effective self-regulations right now, it is a very fragmented, competitive market. Many different funds have many different approaches to how they record assets, to how they make disclosures to investors.... Getting a group of the right people together to try to develop a set of best practice is at least going to start the conversation. Moving forward... we can see what falls out of the process, identify in the results what may be designed to benefit certain funds and certain practices. “

### **The President’s Working Group on Financial Markets**

In the U.S., the Treasury Department last month named two private sector groups to work on best practice recommendations. The voluntary guidelines are to improve disclosure and risk management and are expected to be issued next year. The investor group is lead by Russel Read, head of CalPERS and focuses on due diligence. The manager group is headed by Eric Mindich of Eton Park Capital and focuses on valuation and transparency. This was set up in the belief that market discipline was better than new regulations, and would strengthen the financial markets. (for related coverage, [click here](#)).

### **The U.S. approach – 3 groups, one standing outside the door**

“The U.S. approach is really getting two groups of people in the room, with a third group standing outside the door,” said Mr. Palmer. “The investing population is an important group and the investor group members are looking for standards of disclosure. The fund operators group members are looking at it from a more competitive approach: they are looking at operating standards. Adopting these standards would enable managers to better manage risks and although that entails additional disclosures, if everybody did it everybody would be much better off. Those not doing it will find themselves competing against those who do; and what you’ll end up with is a race to the bottom on standards.”

“The third group, the government regulators, is sponsoring this. As well as looking at investors getting the right disclosure and funds having good operating standards, managing risk and not race to the bottom, the regulators are also looking at the overall implications, at whether there are any structural problem to the economy that needs to be addressed. They rely on the fact that banks, prime brokers, etc. dealing with hedge funds are doing the right thing. I think that is the right approach.”

### **The Hedge Fund Working Group**

In the U.K., hedge fund professionals took the initiative this summer to form a working group lead by Sir Andrew Large. The objective was to review industry standards, valuation best practices, disclosure and risk management. The group issued a 128-page report in September and a later version earlier this month, soliciting feedback from peers (for related articles and 2-part Hedge Fund Standards Consultation Paper downloads, [click here](#)). The FSA welcomed the report (but the trade unions didn’t) and AIMA recently established an investor steering committee.

**The U.K. approach – more one sided**

“In the U.K. they really don’t have the investors’ interests,” said Mr. Palmer. “The dialogue is really among fund managers. I think getting the fund managers together is a great first step to implement operational best practices. But not having the investors involved might actually increase two risks. The first one is that they will not be addressing every aspect that needs to be addressed. The second one is that the standards might be self-serving, they might be designed to quash competition as opposed to simply better the entire industry. Investors will be concerned... That needs to be looked at. The FSA are involved as well because they are trying to figure the market implications of this business.”

**Worldwide standards – maybe not**

“An approach to this is from the top down, where regulators do the best they can to understand the industry and its standards,” said Mr. Palmer. “But there is a lot of information, a lot of market practices and it is really difficult for a single regulator to understand all of that. Also all political forces are prone to abuse. It may be that they are being lobbied or being pressured by certain groups to adopt standards that serve the interest of these groups as opposed to those of the market. I think the reason why we have not seen top-down regulatory approaches meet with success is because there is no grassroots support... That is why I think what is happening now is a much a more grassroots approach to the problem, and (an attempt) to let the right answers come up through dialogues as opposed to simply imposing them.”