



## Hedge Fund Regulation: Systemic risk versus investors' risk

Since the last G20 meeting, regulators over the world are rushing to establish new hedge fund regulations. The creation of new regulations has been in various financial watchdogs' mind for some time, but it is only now that they have the right opportunity and support to push them forward. Indeed, the current financial crisis and disclosure of wide spread fraud schemes perpetrated by numerous fraudsters, including Bernard Madoff, has provided a good catalyst for regulatory change. The main challenge faced by regulators will be to find the appropriate balance between the protection of individual investors' interests and that of the financial system.

In the G20's [Declaration on strengthening the financial system](#), it is stated that "hedge funds or their managers will be registered [...]. Where appropriate, registration should be subject to a minimum size". By introducing a minimum size criterion, it seems that regulators are primarily focusing on the reduction of systemic risk of hedge funds. However, regulators also had to consider other factors in their discussion, such as their limited resources and the fact that too much regulation may impose too heavy a burden on smaller players in the industry. The European Union has been the first to define the minimum size criterion by proposing to regulate investment managers with assets over €250 million. According to Bloomberg, this would bring 76% of EU hedge fund assets under scrutiny.

A likely effect of any new regulation may be the further concentration of the industry. According to a recent study by [Alpha Magazine](#), the top 100 hedge fund managers managed, at the end of 2008, a combined \$1.03 trillion with the top 10 managing \$264 billion. The extra costs associated to more comprehensive regulatory requirements will assuredly put more pressure on already financially unstable managers that have to rely, for the most part, on reduced earnings because of their poor performance in the last fiscal year. However, investment managers have not waited for the adoption of new regulations to acknowledge the demand, from their investors, for stronger operations, as witnessed by the recent Hedge Fund Compensation Study by [GlobCap](#) which found that the "demand for non-financial hedge fund professionals has skyrocketed, and compensation packages earmarked for such positions have climbed in kind". Any newly proposed regulations will allow for certain mandatory changes so as to ensure that we will never go back to where we were before the crisis began. This trend will deeply reshape the industry as investment "boutiques" will have to find new solutions to lower their costs of doing business or they will simply disappear.

Before being published, the forthcoming EU proposal has already been attacked by both private and public persons, such as Luke Johnson from Risk Capital Partners, Martin Schulz, leader of the Party of European Socialists and Christine Lagarde, the French economy minister, and such for very different reasons. Mr. Johnson is attacking the proposed directive on the basis of the equal treatment imposed on both hedge fund and private equity companies, while the Socialist Party claims that the proposal is "filled with loopholes" thus rendering it "highly ineffective". As for, Mme Lagarde, she is unsatisfied with the inclusion of "mutual recognition" in the proposed directive. The French economy minister is one of the few voices that argues for investor protection as an objective for the new directive. The upcoming European election in June will certainly influence the debate about the newly proposed directives and some are worried that it may become a mere political discussion and lose its substance.

A point shared between regulators and investors alike is the need for better transparency. In their declaration, the members of the G20 noted that hedge funds "will be required to disclose appropriate information on an ongoing basis to supervisors or regulators...". The extra disclosure will be for regulators and not investors. Today, information received by the regulators as a result of an examination on a registered investment adviser is considered non-public. In the same vein, the hedge fund managers will also probably ask for the information to be kept non-public in order to safeguard their trade secrets.

The likely effects of the newly proposed regulations or directives are difficult to evaluate today. It will become more scalable for regulators to first ring fence the potential systemic risk caused by hedge fund and then hope that the new rules will also have a positive effect in protecting investors. The newly proposed regulations will be a first step to restore investors' confidence in the capacity of the financial regulators to protect their interest, but the results will probably be only visible in the long run. The regulators will never play the role of a rating agency by passing or failing fund managers, but will certainly act as an additional "guardian" that will at least deter managers from making careless decisions.

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