



If not regulators who will do the job?

The role of regulators is to ensure the stability of financial markets and to protect investors. Recent history has demonstrated the regulators failure to deliver on their core missions. Regulation needs to provide for a balance between market interventionism and liberalism. Also, regulators may overlook the emergence of a new financial risk, crisis are often the results of an excess of liberalism which demonstrate the inability of the markets to self-regulate themselves. The after-mess reaction is usually a sharp U-turn in policy, forcing State intervention in the form of the enactment and enforcement of tougher regulatory rules, which are aimed at reshaping the regulators' image and attempt to avoid the recurrence of past problems. A side effect of this measure is the punishment of the overall industry through more regulatory burden and higher compliance costs. Another issue is that, between the enactment of a new regulation and its application, it usually takes several years to see if the new rules were appropriate for the particular problem and if they had more of a positive rather than a perverse effect.

In other cases, regulators may often realize in hindsight, that if they would have appropriately enforced the existing rules, they could have avoided the pain. This is exactly what happened after the collapse of Lehman Brothers International (Europe) ("LBIE"). The weaknesses of the prime brokerage model, in terms of money protection, are known, but the really annoying part comes when assets, which were supposed to be segregated, end up in the hands of the broker's liquidator and the client ultimately becomes an unsecured creditor. Several former hedge funds clients of LBIE, having fixed income prime brokerage agreements, were informed by the liquidator in June 2009 that their assets had not been treated by LBIE as segregated client money balances.

Surprisingly, in March 2009, the FSA created a CASS (Client Asset Sourcebook) risk team, which is tasked with the measurement and mitigation of risks to client money and assets. The results of the team's first six months of investigation were reported in the Client Money & Asset report published in January 2010. Key findings are summarized below:

✓ There were a few instances where robust governance arrangements and detailed management information helped to provide assurance to senior management that the firm's CASS risks were adequately evaluated, monitored and mitigated.

✗ Inadequate senior management oversight and control was often the underlying cause of more serious CASS breaches.

✗ Overly complex processes around client money and assets led to an increased risk of human error.

✗ Operational and systems changes during transitional periods posed a high risk of segregation errors.

The findings, as worrisome as they appear, demonstrate that should other brokers had "gone under", other clients would have ended up without the proper protection. However, by reading through the report, one realizes also that who else than the regulators can check that clients' assets are held in the prescribed manner to ensure clients protection. It is not realistic for each brokers' client to check each trust acknowledgement letters received from banks, the quality of the brokers' due diligence on banks or the timeliness and quality of the brokers' reconciliation process. The conclusion is that without a well-resourced regulator, one is better to keep his money under the mattress.

The paroxysm of the FSA's chase against CASS-deficient institutions came in June 2010 with the £33.32m fine against JP Morgan Securities Ltd., for failing to protect client money by segregating it appropriately. The FSA gave a strong message to the UK's financial institutions that they should carefully check how they segregate their clients' assets if they want to avoid severe penalties. Again, who else than the UK's regulatory body could have sent such a clear and strong message to get the market back on track?

The lesson for regulators is clear. Before enacting new rules, regulators need first to check that all the current rules are complied with and next to ensure of the scalability and effectiveness of the upcoming rules. Regulators should be careful to concentrate their efforts in areas where the market will not be able to protect itself but they should avoid providing to investors a wrong sense of confidence by promising things they cannot deliver.

Latest Due Diligence

- Cazenove European Equity
- Bluecrest Multistrategy Credit
- Lafayette Street

About Us:

Hedge Fund Appraisal is providing due diligence services to hedge fund investors.

- Compensated only by end investors, achieving complete objectivity
- Appraisals offered on pay-per-use basis, no need for a subscription
- Strong expertise; due diligence is our only service
- Background Check, Operational Due Diligence, Investment Risk Analysis
- Consultancy

For further details, contact us
info@hedgefundappraisal.com