“Hedge Funds”
(Taken from a speech by Marcus Killick
At the Gibraltar Funds Seminar - Geneva
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Hedge Funds have been a significant item on the FSC’s agenda for some time now, reflecting the growth of Gibraltar as a centre of hedge fund activity.

Hedge funds are a major source of market liquidity; they significantly enhance market efficiency and offer access to a range of investment techniques for increasing portfolio diversification. We are committee to playing our part to ensure Gibraltar is an attractive location for hedge funds to be based.

But what are the risks the FSC sees the hedge industry posing to its regulatory objectives? In looking at this we have paid close attention to the approach taken by the FSA in the UK and, in particular the comments made by Hector Sants, Managing Director (Wholesale and Institutional Markets) of the FSA at the recent IOSCO conference.

An outline of Hedge Fund risks in general

Our risk-based approach to supervision applies proportionate resources to firms on the basis of the risks they pose to our regulatory objectives of Market Confidence, Consumer Understanding, Consumer Protection and the Reduction of Financial Crime. The sophisticated investor base of the industry and EIFs in particular, means we place less emphasis on the Consumer Protection and Consumer Understanding objectives than in the retail financial sector. However, the following are some of the key potential risks regulators have identified; although, to be clear, identifying a risk does not say anything about the probability of the risk crystallising.

1. **Serious market disruption and erosion of confidence –** The failure or significant distress of a large and highly exposed hedge fund – or, with greater probability, a cluster of medium-sized hedge funds with significant and concentrated exposures – could cause serious market disruption. It could also erode confidence in the financial strength of other hedge funds or firms which are counterparties to hedge funds.

2. **Liquidity disruption leading to disorderly markets** – The incidence of hedge funds collectively making concentrated investments in complex, specialist, financial instruments, and particular market segments (usually on a leveraged basis), is increasing. Coupled with the increasing sensitivity of their investor base to performance, this can engender a significant liquidity mismatch leading to enforced

asset disposals and consequently volatile and potentially disorderly markets.

3. **Market abuse/insider trading and manipulation** – We believe some hedge funds may be testing the boundaries of acceptable practice with respect to insider trading and market manipulation. In addition, given their payment of significant commissions and close relations with counterparties, they may create incentives for others to commit market abuse.

4. **Insufficient information to inform regulatory action** – Partly because of issues of extra territoriality, regulators may have insufficient reliable and comparable date on which to base informed decisions about risk and consequently proportionate regulatory action to mitigate that risk.

5. **Control and Operational issues** – Reflecting their trading (rather than management) background and their typical ownership structures, some hedge fund managers do not have the optimal skill set or incentives to create an effective control and operational structure. Unsurprisingly, the recent rapid growth of the sector has been challenging for some hedge fund managers, with problems such as late trade confirmations, non-notified trade assignments and novations adding significantly to market-wide operational and credit risk levels.

6. **Valuation weaknesses** – Weaknesses in asset valuation methodologies and processes related to skill shortages and conflicts of interest are creating significant potential for ill-informed investment decisions and detriment to market confidence. Incentive structures, light regulatory oversight and weaker control environments increase the likelihood that hedge fund managers will commit fraud by issuing false valuations.

7. **Retailisation** – Penetration of the retail market by hedge fund investment techniques (referred to here as 'retailisation') poses the risk that consumers do not understand, and firms do not adequately manage, the different risk characteristics of funds or products with hedge fund characteristics that are now entering the retail market (for example, UCITS III funds, structured products and funds of hedge funds with lower investment levels).

8. **Preferential treatment for investors** – Some hedge funds are issuing undisclosed side letters which offer enhanced liquidity and other preferential benefits to selected investors, to the potential detriment of other investors in the fund.

How the FSC has responded

I must start by emphasising the FSC is **not** seeking to authorise and regulate funds, except where they fall into the UCITS, EIF or private fund regimes. Also, it is important to note that the FSC does not have a "no failure" objective. We expect that some funds will go out of business, and indeed we believe this is a prerequisite for a healthy marketplace. Nevertheless, we believe that we can mitigate the risks through effective supervision.

This includes ensuring that participants are fit and proper, make appropriate disclosures and are subject to both on site and off site monitoring. Given the nature of EIF hedge funds, the FSC seeks to ensure its regulatory approach supplements rather than inhibits appropriate growth. You will hear from others how the EIF regime depends heavily on self regulation, with sign off on the documentation made by an independent lawyer rather than regulatory line by line review.

This approach does not absolve the participants of accountability but rather gives them the freedom to manage outside the straight jacket of prescriptive and, in this case unnecessary rules.

In operating in this environment hedge fund managers need to be vigilant around their compliance with market conduct requirements and in particular the market abuse aspect set out in the Market Abuse Ordinance. This is due to their tendency for high portfolio turnover and the consequent high commission generation. It is important that the systems and controls are adequate to deal not just with dealing with market sensitive information, but also to ensure they don't fall foul of the criminal or civil offences.

It is also important for managers to ensure they have adequate systems and procedures for dealing with market sensitive information so that they can deal with any inquiries that may follow from alerts about potential misconduct.

Conclusion

Finally, I believe the best way the FSC can achieve its objectives in the area of hedge funds by being a regulator that:

- has open dialogue with the sector and works in partnership with it;
- only intervenes from necessity where there is a clear market failure and the benefits exceed the costs;
- focuses on the biggest risks; and
- uses limited resources to effectively deal with those risks.

I hope from the approach outlined above we are well on our way to achieving that.