Threat of regulation spurs revamp of hedge fund operations

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It is fashionable to blame hedge funds for the world's ills, and politicians have not waited long before pointing the finger at them over the credit crunch and the subsequent recession. It would be tempting for hedge fund managers to laugh off the often absurd attempts to pin the blame for everything on them were it not for the fact that political posturing could soon be backed up with new regulation of the industry.

Crackdowns have been threatened on everything from short-selling and the use of derivatives to leverage and capital requirements.

This is not the first time such threats have been issued. As Meredith Jones, managing director of US-based PerTrac Financial Solutions, says: 'In 1998, we had LTCM and the industry made the trip to Congress to testify. Then in the high-tech downturn of 2000-2002 it was asserted that hedge funds had taken down the Nasdaq and we had a similar process.'

Jones is not convinced that the current threats will be carried through. After the problems in 1998 and 2000-2002 there was little substantial change, she says. 'What did change, however, was oversight by investors. Before 1998, few hedge funds reported numbers and there was zero transparency. Afterwards most provided information on holdings, exposure and returns. So there was little real regulation but plenty of self-regulation.'

However, Jones accepts that the current environment is of a different order of magnitude and regulation is more likely to result. Manny Roman, co-chief executive of GLG Partners, the New York-listed multi-strategy alternative asset manager, says he expects the industry to have to face a severe regulatory clampdown. 'There needs to be scapegoats, and they are going to go hunt people,' he says. He believes regulation is 'long overdue', adding: 'Someone can leave college on a Friday and start a hedge fund on Monday.'

The larger US hedge funds are likely to choose to be regulated to avoid closer scrutiny down the line, reckons Carmel Peters, an Asian equities specialist at RWC, a USD 2.5bn multi-strategy hedge fund firm based in London. 'The SEC may register more firms and more firms will voluntarily choose to do so,' she says.

Leverage, widely perceived to have exacerbated systemic financial problems, is a potential target area for rule-makers. But Peters argues against new rules in this area, arguing that leverage will reduce naturally as the structure of prime broking changes. 'There appears little reason to legislate. Funds will still lever, of course, but less so.'

And RMF, a Swiss-based seeding firm and fund of hedge funds company, points out that leverage, at least in the short-term, will not be necessary for many funds to make money, given market volatility and distressed asset prices. Hans Hurschler, head of RMF Hedge Fund Ventures, says: 'There is ample opportunity for funds to make excellent unlevered returns in this environment.'

Short-selling is another likely regulatory target, following crackdowns in just about every world economy over the last few months. Tom Brown, head of investment management at KPMG, says: 'Personally, I think the rules will be temporary.' On the other hand, he thinks the uptick rule, where investors can only sell a stock short if the last movement was up, may stick. 'This is sensible since it avoids a vicious downward spiral in a single stock,' Brown adds.

New rules on the use of credit derivatives, widely viewed as the root of recent problems, are most likely of all. Moves to regulate the USD 62,000bn credit derivatives market escalated last month, with New York State planning to bring parts of the sector under the control of its insurance supervisors from January. 'The absence of regulatory oversight is the principle cause of the Wall Street meltdown we are currently witnessing,' said David Paterson, governor of New York, last month, adding that credit derivatives were a 'major contributor' to the crisis.

Market manipulation is a further area of contact for legislators. The Securities and Exchange Commission has pledged to obtain statements - under oath - from hedge fund managers, broker-dealers and institutional investors with significant trading activity in financial issuers or positions in credit default swaps. Richard Jones, chief executive of Fidessa LatentZero, says similar measures should be unnecessary in Europe where trade reporting rules have already been tightened under Mifid. 'Smaller funds delegate this to their prime brokers,' says Jones. This should not be an issue for most hedge funds.'

However, the greatest likelihood of genuine regulatory action exists in capital requirements rules. The European parliament's economic and monetary committee has passed a resolution calling on the Commission to make 'all relevant actors and financial market participants, including hedge funds and private equity' subject to mandatory capital requirements. In response, the Alternative Investment Management Association (AIMA) in October updated guidance to its members on how to implement an Internal Capital Adequacy Assessment Process. Andrew Baker, AIMA's deputy chief executive, says: 'The hedge fund industry has embraced the capital adequacy debate proactively.'

Yes, all the putative measures represent a somewhat desperate response by policymakers to a desperate economic situation and KMPG's Brown, for one, is sceptical about the potential benefits. 'What we need is more supervision and enforcement of the existing regulations, not new rules,' he says. 'I would expect regulators to look at hedge funds with greater resources, greater frequency and depth of probing.'

PerTrac's Meredith Jones agrees. 'It is not very useful to impose industry-wide sanctions on an industry that is so diverse. They could put restrictions on leverage but 30 per cent of hedge funds don't use leverage. There is no panacea from a government point of view.'

Nevertheless, regulators are starting to gather the firepower to enforce existing regulation, according to Fidessa LatentZero's Richard Jones, who says 'Regulators will be able to recruit a higher calibre of person than in the past with the job losses in the financial services markets.'

Whether existing regulations are tightened or new ones introduced, it is clear that the industry needs to act to protect itself. Says PerTrac's Meredith Jones: 'The introduction of additional real regulation will depend on how well the industry responds and educates people. Hedge funds must get out and dispel the myths. That is the only way can they avoid knee-jerk official reaction.'

There has already been a marked trend towards greater transparency - the main concern of politicians and rulemakers - with most hedge fund managers providing weekly or even daily numbers, she says. 'This is a natural evolution of the business,' says Jones. But there are technical difficulties involved in providing the numbers that not all hedge fund managers had yet overcome. She adds: 'We still see many hedge fund managers provide a PdF of the information to investors, who then have to go through it and type in the relevant bits and then do their analysis. Many hedge funds have the information but don't have the ability to share with it a large group of investors.'

And the more complicated the strategy, the more challenging the reporting requirements become. Exotic instruments aside, there is even complexity with plain fixed income funds, which tend to use plenty of leverage to magnify small movements in prices. 'Reporting on the leverage and explaining counterparty risk is no easy matter,' says Jones.

Indeed, counterparty risk rose to the very top of the agenda for hedge funds following the collapse of Lehman Brothers, and is now an essential part of the risk jigsaw alongside operational controls, performance measurement, compliance and order flow control. Fidessa LatentZero's Richard Jones says: 'If you are a single prime-broker hedge fund, you are much more likely to run into trouble.'

But even operational controls - being able to produce a snapshot of all positions and all exposures at all times - are not always in place. Neither are order controls, which enable managers to track whether an order has been placed, executed and settled correctly. Smaller hedge funds often don't have these systems in place even though explicit checks and balances are crucial in exercising control, Jones says.

There is, however, some doubt whether better systems actually solve the problems funds have faced in the recent past. Simon Nathanson, chief executive of Neonet, a specialist technology broker, says: 'I'm not sure if better compliance and performance tracking tools will work. In exotic products you have hidden risks and I don't think people can start to know how to address them.'

Nevertheless, many in the industry believe if hedge funds can get the majority of operational, compliance and risk issues right, they can expect a healthy future. PerTrac's Jones says: 'Hedge fund performance overall is better than the markets or mutual funds. If you are in an index-tracker you are down 40 per cent this year, if you're in a hedge fund you're down 10 per cent or so. It is Darwinian that there will be fewer hedge funds next year, but the groups that get out in front of operational and regulatory issues will do well. Money will definitely flow into this industry again.'

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