HFSB Response to the Treasury Committee Inquiry into proposals for European macro and micro prudential financial regulation

The Hedge Fund Standards Board (HFSB) was set up to act as custodian of the Best Practice Standards published by the Hedge Fund Working Group in 2008 and to promote conformity to the Standards. It is also responsible for ensuring that they are updated and refined as appropriate. Almost 60 managers from the UK and abroad – totaling over USD 200BN in assets under management - have already committed to the process of the HFSB, and more are expected to sign up to the Standards over coming months. The HFSB expects its Hedge Fund Standards to be widely adopted and an increasing number of investors to use the Standards in their due diligence. It is important that policy leaders trust that the HFSB will implement this market based regime with the industry and encourage adoption as well.

The Hedge Fund Standards Board (HFSB) is pleased to respond to the Treasury Committee inquiry into the European Commission's proposals for financial regulation and supervision and, in particular, the detailed proposals for a European Systemic Risk Board and three European supervisory bodies: a European Banking Authority, a European Insurance and Occupational Pensions Authority and a European Securities and Markets Authority.

This paper is structured around the areas the Committee has highlighted in its press announcement and focuses specifically on issues in relation to regulation of the hedge fund industry.

The interaction between EU, national and international regulatory and supervisory arrangements.

The set up and the degree of centralisation of regulatory and supervisory arrangements will depend on the nature of the activity. There is no single approach applicable across all areas of regulatory and supervisory activity. The following differentiates between activities in relation to systemic concerns (1.), vs. regulation and oversight of individual industries (2.).

1. When dealing with issues in relation to systemic risk, supervisory arrangements and activities at European level are required given the cross border nature of systemic issues. However, it is important to highlight that this activity will likely require a more holistic approach than just focussing on specific sectors such as banking, but will require a cross sections of the entire economy. The toolkit required when assessing systemic issues will likely differ significantly from the regular oversight of individual institutions. Interaction with national regulators (as well as international bodies) will be required for data collection and aggregation purposes.

2. In relation to the regulation of individual industries, local regulators tend to have the best and most detailed understanding of their respective industries. Here, the subsidiarity principle needs to be observed.[1]

The current debate on the AIFM Directive is an example for a questionable centralization of powers in Brussels.

- The scope of the Directive is very wide, which has given rise to discontent in many member countries that their respective industries are not adequately catered for by the Directive, and might even be significantly hurt.
- For the UK, the hedge fund industry is one example of a severely affected industry, but other countries face their own issues (such as German open ended real estate fund managers). For the hedge fund industry, the majority of the European industry (~80%) is based in the UK, and the industry is already regulated by the UK FSA.
- There has been no case of failure or weakness in the current regulatory set up of regulation of hedge funds, on the contrary, the UK FSA is considered to be among the most skillful, experienced and also advanced regulators in the world for this market segment. In particular, the UK FSA has started to look into issues in relation to systemic risk in the context of Hedge Fund activity long before the crisis started (eg Prime Brokerage survey).

It is now hard to argue that a centralized approach to regulate this industry from Brussels will be superior in achieving public policy objectives than the hands on approach of the local regulator.

The Banking industry is an example, where local regulators are in charge, while banks are allowed to operate in other European jurisdictions in the context of a European passport.

[1] Subsidiarity is a key pillar of European policy making, whereby it is intended to ensure that decisions are taken as closely as possible to the citizen and that constant checks are made as to whether action at Community level is justified in the light of the possibilities available at national, regional or local level. Specifically, it is the principle whereby the Union does not take action (except in the areas which fall within its exclusive competence) unless it is more effective than action taken at national, regional or local level. It is closely bound up with the principles of proportionality and necessity, which require that any action by the Union should not go beyond what is necessary to achieve the objectives of the Treaty.

A final point about the hedge fund industry puts the regulatory approach in a different light: this is one of the most entrepreneurial and innovative industries that one can imagine. Hedge funds only survive if they outperform, and this requires a permanent search for innovation: new ways of investment, new strategies of value creation. These innovations are then copied by the whole asset management industry and we all benefit from them. And all of this happens in an incredibly competitive market, where investors are fully in charge.

Hedge funds are, in many ways, the Silicon Valley of finance. One can wonder whether Silicon Valley would ever exist if the law were to regulate in detail the activities of these firms, including the compensation of successful entrepreneurs.

In summary, the HFSB would favor that more powers are given to the national regulators in particular in the context of innovative industries such as the hedge fund industry. More generally, we believe that national regulators are best positioned to identify the required measures in the context of their respective national alternative investment management industries.

The composition and internal structures of the supervisory authorities and the ESRB, and whether the powers proposed for these bodies are appropriate

The HFSB is not convinced that a significant concentration of powers is needed at the European Commission.. There is significant risk that the quality of regulatory oversight will decrease, ultimately leading to higher risks for all market participants, including investors and depositors.

-> To avoid this, national regulators will need to maintain significant powers. (1.)

-> Private initiatives such as the HFSB, which represent a complement to legislation, need to be strengthened. (2.)

The following points elaborate on the second conclusion above, and highlight the importance of Standard setters such as the HFSB as part of the regulatory architecture.

- It has long been recognized that relying on legislation alone is not always effective. The reasons for this include the slow pace of the legislative process as well as the inefficiency of relying on the courts as the only mechanism to address issues of compliance and sanction.
- Consequently systems of regulation have been created which are designed to be more flexible and which enable behaviours to be shaped through a combination of regulatory direction, intervention and sanction. Such systems include Principles, Rules and Standards (such as the Hedge Fund Standards).
- **Standards** are typically less granular than rules, but generally set out the principals of behaviour required in greater detail than can be achieved in the legislation or the principles themselves. They are specific to particular areas of business such as Hedge Funds or to an area where detailed rules themselves are impossible to draw up in a meaningful way like Governance. Standards are an appropriate way to express required behaviours in fast moving areas of business and to ensure that such principles of behaviour keep pace with the development of that business. They can allow for exceptions whilst still aiming at the same behavioural outcome intended by the legislation and the principles. The alternative would be for overly detailed rules in order to accommodate exceptions etc. But this can lead to

complexity, rigidity and to parties circumventing the spirit of the rules by adapting new definitions, technical business models or escaping to jurisdictions where the rules do not apply.

The proposals' effect on the competitiveness of the European financial industry in general and the City of London in particular

This answer relates specifically to the Hedge Fund industry:

Hedge Funds are a key component European financial markets. They are significant liquidity providers, contribute to efficient price discovery, provide capital and innovate new ways of investing (and these innovations are then copied by mainstream investors), and most importantly, they provide value for their investors.

The nature of the industry is very entrepreneurial, the compensation model is very strongly linked to performance, and when performance is inadequate, the sanction is swift: investors are sovereign, they withdraw their money quickly and hedge fund managers suffer accordingly, often going out of business. There is hardly an industry which is more rigorously subject to the market test, and where the sanction for mediocrity is more rapidly felt.

It is important to ensure that this entrepreneurial "silicon valley" of financial markets is not hampered, and that barriers to entry into this area of activity are not unnecessarily raised. Current regulatory efforts in the alternative investment area raise significant concerns that this innovative activity will be impaired. The impact would be felt beyond the jobs (and continuous new job creation) in this area of finance in the City of London and elsewhere in Europe: This would lead to less efficient, less complete and less attractive capital markets in Europe.

In order to preserve the competitiveness and quality of European capital markets, it is important that all regulatory initiatives are anchored in a solid intellectual foundation, such as the findings in the De Larosière Report. It is also important that despite the perceived urgency and political pressures in light of the recent financial crisis, principles of better regulation should be permanently observed and followed.