ASIC

Australian Securities & Investments Commission

Reshaping the regulatory–industry relationship

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Australian Securities and Investments Commission

The Australian Hedge Fund Forum

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Today, after a two-year gestation period, two public consultations and further targeted consultation, I am pleased to announce the release of ASIC's new regulatory guide on hedge fund disclosure, Regulatory Guide 240.

I will return to the regulatory guide in a moment, but first I wanted to observe how it is fitting to announce its release at an AIMA-sponsored event, after all the constructive input we have had from AIMA—be assured, not all of it laudatory—since the development process began at the end of 2010. That input is part of wider and ongoing dialogue we've had with many in the industry. Indeed, I hope that as I discuss ASIC's hedge fund work it will be clear how often ASIC turns to industry and investor stakeholders for input into our regulatory and supervisory process, and how those processes are the better for the insight our stakeholders provide.

What is driving ASIC's focus on hedge funds?

With our June class order exempting hedge funds from the shorter PDS regime and today's release of our disclosure regulatory guidance, hedge fund managers may be wondering why they are the recipients of so much ASIC attention. There are drivers to discuss. But I wanted to say at the outset, one of the advantages of having been the Secretary General of IOSCO over the last four years is the perspective it gave me on the great breadth of regulatory initiatives underway internationally. Closer hedge fund supervision is just one of many post-GFC developments locally and internationally. There are many far-reaching regulatory initiatives underway in the regulation of, say, banking, markets infrastructure and OTC derivatives. In the funds sector, exchange traded funds and money market funds are also the subject of regulatory focus.

In November 2008, the G20 called for the closer oversight of hedge funds as part of a wider package of financial sector reform. It was not clear then, and may never be, what role (if any) hedge funds played in precipitating the financial crisis, the first obvious signs of which were the collapse of two Bear Stearns hedge funds in July 2007, our own Basis Capital in August 2007 and a number of BNP-sponsored hedge funds in Europe in September of that year. Were they simply 'canaries in the coal mine', or were they in some way real precipitators of the crisis to come? Regardless of your own personal view on that, regulators perceived that hedge funds had, at the very least, not fulfilled a role as moderators of prices in the crisis run-up or, more importantly, as providers of much needed liquidity as the crisis peaked. These concerns were compounded by the Madoff scandal in late 2008.

It was against this backdrop that IOSCO convened its Task Force on Unregulated Financial Entities in late 2008 to consider hedge fund supervision. ASIC is a member of the 15-member Task Force. In June 2009 the Task Force issued its final report calling for closer sector oversight. Notably, it called for greater levels of disclosure to investors and regulators, for consideration to be given to appropriate prudential measures with respect to hedge funds and their prime brokers, and greater cooperation and information sharing by regulators across borders.

Increased disclosure to regulators reflects an appreciation of the role securities regulators can and should play in mitigating systemic risk in financial markets. The extent of this role and how it will interact with the mandates of banking supervisors and central banks is still being worked through, but we can be confident it will include monitoring systemic risks posed by funds—including hedge funds.

There is no consensus around the systemic risk that may be posed by hedge funds. One form such risk may take is the collapse of a large and/or highly leveraged fund which may impact on their counterparties. An obvious example of this was the collapse of Long Term Capital Management in 1998, where the New York Fed had to orchestrate a bail-in by its investment bank counterparties.[1] It may be that one or several hedge funds may dominate, and so distort or be in a position to manipulate, some strategically important security, market, or commodity. The collapse of Amaranth Advisers and its impact on the US natural gas futures over the northern summer of 2006 illustrates how this might occur.[2] Correlated trading by hedge funds might also lead to market instability. The short-squeeze of Volkswagon stock in 2008 is a case in point.[3]

So it is sensible that securities regulators work to understand better the potential for systemic risk to arise or be amplified through the activity of the funds sector, including hedge funds in particular. ASIC's survey of Australia's largest hedge funds in 2010, as part of a wider IOSCO Task

[1] LTCM pursued a relative value arbitrage strategy, investing mainly in government bonds. In August 1998 it held US$125 billion in assets against only US$4.1 billion in equity (i.e. leverage of 25:1). A market crisis led to risk spreads and liquidity premiums rising, confounding LTCM's risk management models. As other markets were impacted, LTCM's positions were found to be more correlated than had been supposed. With the fund's liquidity evaporating and its capital collapsing the New York Fed sponsored talks between its principal counterparties which led to a consortium of 14 buying into LTCM. Thereafter the fund's positions were unwound. See Report of the President's Working Group on Financial Markets, *Hedge Funds, Leverage and the Lessons of Long-Term Capital Management* (April 1999).

[2] Amaranth collapsed in September 2006. Throughout that summer it dominated the trading in natural gas contracts on NTMEX and ICE (controlling as much as 40% of the outstanding contracts on NYMEX for natural gas in the 2007 winter). Its trading led to significant price rises over summer but, in the face of stable supply and demand (and ample reserves), these positions could not be sustained by late summer. From late August through mid-September the fund lost US$2 billion leading to liquidation of its US$8 billion portfolio. During this process gas prices collapsed. See Staff Report of the Permanent Subcommittee on Investigations of the US Senate, *Excessive Speculation in the Natural Gas Market* (2007).

[3] On 26 October 2009 Porsche, which was known to hold 35% of Volkswagon's stock, announced it had lifted that stake to 42.6% and that it had cash-settled call options that would raise its stake to 74.1%. Many hedge funds, assuming Porsche was not going to take over VW and that VW's business would decline in the recession, had shorted 12% of VW's stock. With a free float of less than 6%, funds rushed to close out their shorts and the price of VW stock skyrocketed, making it briefly the most valuable company in the world on 28 October. Porsche agree to make 5% of its stake available to settle transactions and by Friday 31 October the price had fallen to 20% of its Tuesday peak. The DAX significantly over-performed and then under-performed world indices over the week. Some funds are still pursuing Porsche in the US and German courts. See 'Squeeze money', *The Economist*, 30 October 2008; 'Watchdog on alert after Volkswagon shares plunge', FT.Com, 30 October 2008; 'Porsche plaintiffs suffer setback to $5 billion claims', *New York Times*, 27 June 2012.

Force member survey, is an example of ASIC assuming a role in monitoring the build-up of systemic risk. A second survey is planned for later this year and will be the first to include US and Singaporean hedge fund managers.

These surveys allow us to see levels of sector leverage, liquidity dynamics, participation and turnover in various markets and products, and the levels of exposure to different counterparties. Aggregated results are shared with other Task Force members and our local sister agencies, the Australian Prudential Regulation Authority and the Reserve Bank of Australia. While each survey is useful in and of itself, their utility will be enhanced when we can draw comparisons with data from previous surveys. This comparative analysis should help us see emerging trends.

I should add that AIMA played a valuable role in helping us customise the survey template for the local market.

The Madoff scandal in late 2008 led regulators globally to investigate whether they had similar fraudulent hedge funds. Regrettably, Madoff was not an isolated case. Some of the more notable frauds include Weavering in the UK[4] and AIJ Investment Advisors in Japan.[5]

Locally, we commenced our first manager fraud-related surveillance in mid-2009. Through that surveillance we used a variety of indicators or red flags to identify funds that exhibited higher risk characteristics. The Trio/Astarra group of fraudulent funds came to light during that exercise.

Trio/Astarra highlighted many failings in the system, a number of which are the subject of recommendations in the Parliamentary Joint Committee report on the collapse of Trio which was published in May this year. Our views on the many issues raised are set out in public submissions to the PJC, so I do not wish to dwell on them here. One clear lesson though is that ASIC and the investment community need to be vigilant about the potential for manager fraud.

Consequently, we are now wrapping up our second fraud-related surveillance, which has been focused on potential indicators of asset misappropriation, returns manipulation and fee entitlements. We have also conducted a smaller exercise focused on asset valuation.

Pleasingly, industry intelligence figured in both our major fraud surveillances. ASIC welcomes this input, takes it seriously and respects

[4] The UK-based manager of the Weavering Macro Fixed Income Fund hid losses on futures and options by setting up bogus swaps with an entity he controlled. The US$600 million fraud was uncovered in 2009 as mounting investor redemptions could not be paid out.

[5] AIJ Investment Advisors managed US$2.6 billion in two funds trading (allegedly) in equity and bond futures and options. It was suspended by the Japanese FSA in February 2012 after it could not account for its client's funds. Its manager, who had a criminal history, had set up a number of bogus offshore service providers to help hide the fraud through invented trading and returns.

confidences. This input reflects an acknowledgement that ASIC and industry have a common interest in rooting out manager fraud as it undermines investor confidence in the sector.

On investor disclosure, one area where the Australian regulatory regime falls short of the IOSCO blueprint is our investor disclosure regime. IOSCO's 2009 report called for mandated disclosure of a range of issues, including risks, strategy, fund performance, and so on.

ASIC has also, since 2009, conducted ongoing reviews of hedge fund Product Disclosure Statements (PDSs) and found the quality of disclosure varied widely from everything we could hope for through to very poor, and even misleading, disclosure. This uneven quality of disclosure has been a significant concern. In this context I should repeat that ASIC's first strategic priority is to encourage confident and informed investors, and adequate disclosure that empowers investors to make a reasonable investment decision is core to that aim.

As a result we began an extensive public and industry consultation process back in February last year that led ultimately to today's release of a regulatory guide on hedge fund investor disclosure.

Defining hedge funds

When you issue guidance to a sector of the market, you have to be able to identify those to whom the guidance applies. But a more pressing imperative was the mandated compliance, from 22 June this year, by 'simple managed investment schemes' with the shorter PDS regime.

That regime defines 'simple managed investment schemes' by reference only to whether a retail fund can liquidate 80% of its assets at market value within 10 days. Our analysis suggested the great majority of local retail hedge funds could satisfy this test.

ASIC has long maintained that the complexities of, and diverse risks posed by, hedge funds cannot be adequately explained to retail investors in eight pages. I am pleased that this was acknowledged in our discussions with AIMA.

If hedge funds were to be excluded from the shorter PDS regulations, we needed to develop a robust and defensible definition in the class order.

As there is no universally recognised definition of 'hedge fund', our initial approach was to define hedge funds by reference to common characteristics associated with them that are of regulatory concern, such as the use of leverage, derivatives or short selling.

Next, we checked this against approaches used by international regulators, industry associations and other bodies such as IOSCO and the President's Working Group on Financial Markets. All define hedge funds by reference to lists of fairly common criteria, though the context and implications of satisfying these definitions varied. The criteria we settled on are generally consistent with, but more liberal than some of, these other approaches.

Under the class order and RG 240, a hedge fund is defined as a registered managed investment scheme which is promoted by the responsible entity as a 'hedge fund', or it exhibits **two or more** of the following factors:

- use of a strategy to produce a low correlation with equity or bond indices or of a complex investment structure
- use of leverage for investment purposes
- use of derivatives (with limited exceptions for FX and interest rate hedging or short term portfolio replication for efficiency purposes)
- use of short selling
- rights to charge a performance fee.

A 'fund of hedge funds' is defined as a managed investment scheme where at least 35% of its assets are invested in one or more hedge funds (including a fund in or outside this jurisdiction that would be a hedge fund if it were a local registered managed investment scheme).

In adopting this definition we took account of industry feedback on the definition used in consultation papers. A consistent theme was the need for a responsible entity to be able to determine with certainty if the fund was in or out of the shorter PDS regime.

As the shorter PDS regime is embodied in regulation, certainty in application is also needed to ensure courts can apply the test consistently and ASIC can supervise the shorter PDS regime with some confidence.

The need for certainty suggested we avoid using 'generally regarded' type tests or tests that use 'materiality' thresholds.

Nevertheless, we were alive to the difficulties that drawing 'bright lines' across a spectrum of market practice might entail and of the desirability for some level flexibility. We found an answer in IOSCO's approach. It defines hedge funds as funds that manifest two or more of its specified criteria. Adopting this approach meant more traditional funds only manifesting a single characteristic more commonly associated with hedge funds will not be caught.

Again, local industry had played a role in recommending this approach to us.

Hedge fund disclosure

We have adopted the same approach to defining hedge funds in our new disclosure regulatory guide, RG 240. While the guide is directed at responsible entities of retail funds, we hope managers of wholesale funds will take account of RG 240 as well.

Those of you familiar with our last consultation paper (CP 174) in February will be not be surprised by the content of RG 240. As you will all be able to comb over the details later today, I do not want to dwell on them. Basically it includes two benchmarks, where we expect disclosure on an 'if not, why not' basis:

- independent valuation of non-exchange traded assets, and
- annual and monthly reporting to investors of important basic information

and nine disclosure principles covering:

1. the fund's investment strategy and how it works
2. the investment manager's background and experience
3. fund structure, jurisdictions involved and related parties
4. types of assets held, how valued, how held and where located
5. the fund's liquidity and liquidity management
6. level and use of leverage
7. purpose and types of derivatives used
8. the use and risks of short selling
9. the making and freezing of withdrawals.

The disclosure benchmarks and principles were influenced by:

- our experiences since 2009 in reviewing a large number of hedge fund PDSs
- two public consultations, targeted industry consultations on various drafts and a number of industry meetings over the last two years
- analysis of international regulatory regimes, and
- the Trio/Astarra case.

In the final version of RG 240, there are a number of changes that were made as a result of submissions we received during the consultation, including on such issues as:

- removal of an independent custody benchmark
- simpler fee disclosure more in line with prevailing industry practice

- the treatment of funds of hedge funds and a lifting of the threshold beyond which underlying funds should be the subject of full disclosure from 25% of NAV to 35%, and
- extension of the period managers will have to conform to the regulatory guide, which was originally from February next year (when the period of grace under our recent class order was set to expire) but has now been changed to 22 June to align with the expiry of the new class order, which will also be modified to allow funds with an existing PDS until 22 June to issue a longer form PDS.

Industry input also led to clarification of several areas, including which disclosures we consider need not be made by responsible entities of funds where the disclosure benchmarks or principles are simply not relevant (e.g. where the fund doesn’t use derivatives or leverage).

International influence to continue

Just as international developments have influenced our work thus far on systemic risk, disclosure and manager fraud, the international dimension will continue to figure in our work going forward.

Regulators understand that in global markets with many participants—including many hedge funds—investing and raising capital across borders, regulators need to coordinate their supervision and information-sharing to protect markets from cross-border systemic risk, regulatory arbitrage, misconduct and investor fraud.

In our view IOSCO needs to lead this effort in the securities regulation arena and its regulatory principles need to be the touchstone for coordinated regulatory development. We will work with the Government and like-minded regulators to resist the extraterritorial reach of unilateral regulatory action, where we consider that action is not in the best interests of this market.

Another international development of note is the Financial Stability Board’s focus on shadow banking. There are various streams to this work including IOSCO work in developing methodologies to identify systemically relevant funds—including hedge funds. Another stream is looking at the potential systemic risk posed by securities lending and repo. This stream is likely to be more focused on the activities of prime brokers than hedge funds, but there could be some implications for the wider market.

ASIC needs industry input

It should be evident from my discussion of our efforts in systemic risk monitoring, disclosure and manager fraud just how dependent this work is on a constructive dialogue with industry. Industry may not always approve of what we do but I hope we can continue to draw upon your input in shaping our regulation and assisting in our supervision. We may not always get it right, but we are much less likely to get it wrong with the benefit of industry insight.

Over the last three years ASIC has reached out to participants in the hedge fund sector for one-on-one meetings to discuss a range of issues of concern to them and us. We have met with managers, investors, asset consultants, research houses, administrators, custodians, legal advisers and prime brokers. I will be encouraging the team to refocus on sector engagement as the Commission places a high priority on a constructive dialogue with industry.

Of course we cannot meet with all sector investors, managers and service providers but we will try and meet with a representative cross-section. Consequently, it is very important that you all continue to work through your industry associations, like AIMA and the FSC, to ensure we have the benefit of the widest spectrum of views.

In conclusion, we do not think ASIC's relationship with industry needs reshaping so much as it needs continued nurturing, including through ongoing and open dialogue.