

Regulatory and litigation risks arising from hedge fund failures

by

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In his book on the Great Crash of 1929 JK Galbraith in a typically acerbic comment referred to the task of financial services regulation as the most unrewarding of activities, justified only by the need to accept the lesser evil.

“The regulation of economic activity is without doubt the most irrelevant and unrewarding of the public endeavours. Almost everyone is opposed to it in principle; its justification always relies on the unprepossessing case for the lesser evil. Promulgation and enforcement of laws and regulations is by grinding bureaucracies which are ceaselessly buffeted by criticism. In recent times it has become obligatory for the regulators at every opportunity to confess their inadequacy, which in any case is all too evident.”

I hope you will not regard a discussion of the UK regulatory system as completely unrewarding. For I want to discuss this morning the impact of that system on the liabilities that may arise when a hedge fund fails in circumstances where it is unable to make full repayment to its investors.

What liabilities may arise from a breach of regulatory rules by the investment managers either in their dealings with the fund assets or in their dealings with investors? In particular what is the impact of the market abuse regime? Where the investment in the

fund was made by a fiduciary, such as a pension fund trustee, in what circumstances may the fiduciary find himself exposed to liability to beneficiaries?

In summary as I shall show hedge funds whose investment managers are located in London are subject to regulatory control under the UK financial services regime, and that regime may give rise to civil liability to investors, and to others, in the event of a fund failure. In particular the market abuse regime has a very wide application. And trustees or pensions funds who invest in alternative assets may themselves be exposed to liability to their beneficiaries or pensioners in the event of a fund failure.

Perspective

I address these points from the London perspective of English law and regulation by the FSA. The most recent figures suggest that there are some 450 hedge fund investment managers in the UK, managing 80% of the \$450 billion of hedge fund assets managed from Europe ¹.

So although you may regard this as small beer, it is not an irrelevant perspective for practitioners in the fund management industry in the Cayman Islands. There will be many funds administered from Cayman, whose investment managers will be located in London, and thus subject to regulation by the FSA as performing regulated activities -- namely advising on and managing investments -- governed by the Financial Services and Markets Act 2000 ("FSMA"). The investment management firm will be regulated as an authorised person and senior management and traders will be required to be approved as fit and proper to perform controlled functions. For these fund managers, their prime brokers are also likely to be situated in London and they will also be subject to regulation by the FSA.

¹ Hector Sants speech 20 November 2007

As you will be aware the FSA in these circumstances does not seek to regulate the underlying offshore fund, and in particular its risk profile². That regulation would be beyond its jurisdiction which extends only to persons carrying on regulated activities within the United Kingdom. So there is no direct supervisory control of the constituents of the fund, its risk management systems or its relations with investors.

The FSA would dispute that it applies a light touch approach to the regulation of hedge fund investment managers³, but it is clearly the case that historically the risks to the FSA's objectives posed by the activities of hedge funds in London have been seen as low and supervision has been adjusted accordingly. A primary concern of the FSA is the protection of retail investors and as the marketing of hedge funds to retail investors is currently restricted, the approach is that sophisticated investors should be able to take care of themselves. As the investment manager deals with the hedge fund or its administrator offshore, then again the relationship between the offshore fund and its investors should not be a concern of the UK regulatory system.

But where the investment manager is located in London then the investment management activities will in effect be subject to conduct of business and management regulatory control by the FSA. The investment manager will be subject to the FSA Principles, FSA rules and the market abuse regime. The rules applicable will include Conduct of Business Rules and Systems and Controls requirements focused on senior management. The FSA is moving towards a more principles based regulatory regime so many of these requirements are fairly general in nature. For example all the detailed rules on money laundering procedures have been removed, to be replaced by a general obligation on senior management to maintain proper systems and controls to prevent money laundering.

But the fact that these are generalised obligations merely increases the risk of subsequent enforcement action when it is discovered that errors have been made.

² FSA DP 16 / 2002 para 4.22 – 4.25

³ Speeches by John Tiner 20 November 2007; Margaret Cole 4 October 2007

Thus although the FSA purports only to regulate the investment manager in respect of the conduct of its business with the fund, through oversight of the investment manager the regulator will supervise all the investment activities carried out on behalf of the offshore fund.

In particular the investment manager in the conduct of its business will be subject to the Principles for Business which covers all its regulated activities including Principle 1, the fundamental obligation to conduct its business with integrity. As I shall explain that fundamental general principle is actually quite a powerful regulatory tool in controlling the activities of the investment managers. So although the fund itself is beyond the jurisdiction of the FSA, the regulatory approach adopted will have an important influence on how the fund is managed.

It is clear that in respect of its trading activities the investment manager will be subject to the conduct of business rules applied by the FSA. What is less obvious, but appears to have been generally accepted, is that UK regulation will also affect the relationship between the hedge fund and its investors.

We have seen this already in the steps taken, for example, to regulate valuation practices and the use of side letters by hedge funds. In March 2006⁴ the FSA published a statement making clear that it was stepping up its supervision of investment managers in relation to valuations. It noted:

“Hedge fund managers may be exposed to conflicts of interest as their remuneration is based on performance and assets under management. This may create an incentive to overstate the valuations it provides to administrators, who may not be able to challenge them. Themed visits are currently being carried out in this area ...”

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⁴ FSA/PN/026/2006 23 March 2006

However despite this tough public statement there has been only one instance of enforcement action taken against a hedge fund manager for misstating valuations ⁵, and in that case, where the fund had become insolvent, the FSA appears to have accepted a very light penalty. So enforcement action in this area has not been conspicuous, but on the other hand it cannot be said that the industry has not been warned. So to date in the area of valuations the regulator has been relying primarily upon the industry to improve its own practices.

And it is only fair to the FSA to point out that the warning it gave in 2006 about the difficulties of fairly valuing assets which cannot easily be marked to market has proved to be highly prescient.

On side letters the regulator said that the failure by hedge fund managers to disclose that side letters have been granted to certain clients may result in some investors receiving more information and preferential treatment to other investors in the same share class. The FSA has made it clear that a failure to disclose the existence of side letters to all investors in the fund would potentially be considered to be in breach of Principle 1 -- a firm must conduct its business with integrity – and a breach of Principle 8 – a firm must manage conflicts of interest fairly ⁶.

As a minimum the regulator would expect acceptable market practice to be for investment managers to ensure that all investors are informed when a side letter is granted and that any conflicts that may arise are adequately managed. In principle it seems very difficult to justify preferential treatment for some investors of the same class.

This is a clear instance where the FSA, although disclaiming any intention to regulate the fund, is through its supervision of the investment managers in London able to influence market practice and the treatment of investors. In both these aspects it is investors in the funds whose interests may be prejudiced, and the FSA Principles are being used to ensure that they are fairly treated.

⁵ *Regents Park Capital* FSA Notice 23 March 2006

⁶ FSA Feedback Statement 06/ 2

I shall return later to the question whether investors in a failed fund who have been disadvantaged by a valuation abuse or by the grant of preferential terms to other investors may have remedies under English law against the investment managers.

Market abuse

I now turn to a discussion of the market abuse offence created under section 118 of FSMA, as amended and widened from 1 July 2005 to conform with the European Union Market Abuse Directive. I emphasise this aspect of the regulatory regime because this is a key risk for investment managers.

In general terms the Act penalises behaviour which is based on inside information, or which gives a regular user of a market a false or misleading impression as to price or value of investments, or which distorts a market. The Act applies to all regulated United Kingdom markets and to investments traded on those markets. It covers all investments admitted to trading on a market but also derivatives of those investments.

Inside information is very generally defined.

You may be wondering whether the potential for allegations of market abuse is likely to have much relevance to funds registered in the Cayman Islands, particularly where the investment manager is not located in the United Kingdom and is not subject to regulation by the FSA.

The first point to make is that the offence may be committed not only by an authorised or approved persons subject to regulation by the FSA, but by any person who engages in behaviour prohibited by the Act. So any investment manager or trader – whether or not regulated by the FSA – is subject to this provision. Furthermore the offence covers not only those who actually trade or commit the market abuse but anyone who encourages another to commit market abuse⁷.

⁷ FSMA 2000 section 123 (1)

The second point is that the section covers prohibited behaviour which takes place not only in the United Kingdom, but also outside the United Kingdom if it relates to the investments traded on markets covered by the section. The Act originally covered only prescribed markets in the United Kingdom, but even that apparent limitation is not what it seems for reasons which I shall explain.

The purpose of the market abuse provision was to overcome the historic difficulty of securing any criminal convictions for insider trading. The hope was that by the creation of a civil offence, thus changing the standard of proof to a civil standard, and removing the decision making from a jury to an expert regulator, with an appeal to an independent specialist tribunal, previously unpunished improper conduct would be properly dealt with. But it is very difficult to make up for a lack of evidence by the creation of a more stringent offence.

Last year Linda Thomsen, Director of the Enforcement Division at the US Securities & Exchange Commission, commented that "it is important to understand how difficult it is to build an insider trading case. They are, unquestionably, amongst the most difficult cases we are called upon to prove, and despite careful and time-consuming investigations, we may not be able to establish all of the facts necessary to support an insider trading charge."

As both the SEC and we know "piecing together an insider trading case can be a complex, painstaking process. It is rare to find a "smoking gun;" virtually all insider trading cases hinge on circumstantial evidence. It is quite common for insider traders to come up with alternative rationales for their trading strategies that the staff must refute with inferences drawn from the timing of trades, the movement of funds and other facts and circumstances."

The difficulties of obtaining anything more than circumstantial evidence in insider dealing cases remains the same as ever, and the provision has not been a conspicuous success. Indeed all the indications are that the FSA proposes in future to make more use of the prosecution of criminal offences, because of the difficulty it has experienced in securing convictions for market abuse.

But the market abuse offence has certainly substantially increased the regulatory risks for investment managers. A key priority of the FSA's Enforcement division is market abuse by hedge funds and their prime brokers. In a speech in 2006, Margaret Cole, the FSA's Director of Enforcement, said:

"Of particular interest to us in Enforcement is the FSA's belief that 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 be creating incentives for others to commit market abuse" ("The UK FSA: Nobody does it better?", 17 October 2006)⁸.

The area of particular interest is systematic and repeated abuse of the market: *"one area that we have said is a priority is what we call systematic market abuse -- market abuse that isn't just a one-off but where there are organised rings"*⁹. Although the FSA rightly say that when compared to the SEC, it is not an enforcement-led regulator, it remains very keen to pursue enforcement action against hedge funds and traders suspected of insider dealing. The aim is to deter, using enforcement action to send messages to the market that standards of conduct need to rise.

One detects in the Enforcement statements made by the FSA two general themes which cause them to consider that hedge funds pose a particular risk to market integrity.

The first is the industry wide fee arrangements – the 2 + 20 model – which give a systemic incentive to generate high returns on a monthly basis, even at the expense of subsequent performance. Investment advisers tend to emphasise the benefits of aligning

⁸ http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1017_mc.shtml

⁹ <http://law.fordham.edu/ihtml/news-2itndetails.ihtml?id=638&nid=389>

the interests of the manager with that of the investor, but there is no true alignment for the manager shares only in the upside months, not the downside. At any rate the regulator sees this as an incentive to misconduct.

The second theme is a product of the degree to which the prime brokers have become dependent on their hedge fund clients for the production of income in the form of brokerage and fees. This clearly is a concern for the regulator, presumably based on market information not publicly available.

However despite some tough talk from the regulator little evidence has emerged upon which it has been able to mount major cases of market abuse. There have been a number of market abuse cases but most have been of fairly small fry¹⁰ and generally have not involved what is perceived as the main concern – dealing in the markets ahead of takeover announcements.

A notable exception is that brought in 2005 against the hedge fund GLG and its star trader Philippe Jabre arising out of share dealing on the Tokyo market ahead of a convertible bond issue by Sumitomo.

That is an interesting case because it illustrates the impact of the market abuse regime on market practice, the long arm reach of the market abuse offence, and the extent to which a decision by the United Kingdom regulator will influence practice on the markets globally.

In that case the conduct in question was the selling of shares short on the Tokyo Stock exchange. As the shares in question were clearly traded only through the Tokyo market the argument was that the Act had no application and the FSA had no jurisdiction.

There was no evidence that the London market had been affected in any way, because it

¹⁰ “Since 2001 when we obtained our powers under FSMA we have for example, taken action against an accountant who traded on the basis of information he obtained about a proposed company sale through being involved in the audit of that company, a credit risk and treasury director who placed spread bets on downward price movements of his employer’s shares and on a finance director for passing on information about his employer on which a friend traded.” Director of Enforcement FSA – speech 4 October 2007

was closed at the time and the volume of trading on that market was minimal. Although the instructions to sell had been given from London the market abuse provisions only applied if the abusive behaviour occurred in relation to investments “traded on a market to which (section 118) applies”, ie. a regulated United Kingdom market. However because the shares were also listed in London -- albeit that they had not actually been traded in the transactions of which complaint was made, the Financial Services and Markets Tribunal held that the FSA did have jurisdiction to penalise the firm and a trader for market abuse ¹¹.

Under the new regime applying from 1 July 2005 the position is beyond doubt because the Market Abuse Directive applies to any investments which are “admitted to trading” on a prescribed market ¹². The prescribed markets include not only the United Kingdom regulated investment exchanges, but – if the relevant conduct occurs in the United Kingdom – any regulated market in the European Economic Area. One of the aims of the directive was to secure a comprehensive prohibition on market abuse by ensuring that traders could not avoid the regime by placing trades through markets in other countries.

So in principle the market abuse provisions will apply to any investment manager who engages in behaviour which affects a United Kingdom market or engages in behaviour which affects investments which are listed on a United Kingdom market or derivatives on such investments, even if the transactions in question took place on an overseas market.

Prior to the *GLG & Jabre* case market practice on the marketing of convertible bonds to hedge funds as potential buyers can best be described as mixed. There was no consistency of practice as to whether a fund approached should formally be made an insider, or whether it would be improper for the hedge fund to go into the market – ahead of the bond issue – to short the shares as pre-hedge against the convertible bond issue to which it had agreed to subscribe. It was generally accepted that it would be a misuse of the inside information to short the shares otherwise than as a hedge against

¹¹ *Jabre v FSA* FSMT Decision July 2006 – www.financeandtaxtribunals.gov.uk

¹² FSMA section 118 (1) (a) as amended from 1 July 2005

the bonds, but there was some doubt as to whether it would be proper to sell short as a pre-hedge against the issue or even to enter into arrangements to borrow the shares for that purpose in advance of the issue. In April 2003 the FSA issued a policy statement informing hedge funds that it would view any attempt at pre-hedging before an issue of convertible bonds as amounting to market abuse¹³, and that it would not be acceptable to make arrangements to borrow shares for the purpose of selling short once the bond issue was announced to the market. Thus in effect the regulator was laying down the limits of acceptable practice for all hedge funds participating in convertible bond issues. Those limits would be enforceable against any hedge fund globally which contravened those limits in respect of securities listed on the London markets, whether or not the transactions were on those markets, and be enforceable by penalties for market abuse.

Almost exactly at the same time as the FSA announced its views the Japanese regulator raised concerns about short sales of Sumitomo shares on the Tokyo market ahead of a convertible bond issue in February 2003. The case raised all the usual difficulties of distinguishing between market information and inside information. It was well known that Sumitomo was in need of capital and would need to make an issue of shares or bonds. The hedge fund had already made arrangements to borrow a massive line of stock with a view to selling it short, and had already started to sell. The trader accepted he had then been asked for his views by the bank proposing to handle the issue, which was also the fund's prime broker who had provided the shares on loan, and was in terms taken over the wall, but understood there was no settled intention to make the bond issue. He disclosed that he was selling short and asked if he was clear to continue. He understood, erroneously as it was later decided, that the bank had given him clearance to continue.

The FSA found the charge of market abuse proved and imposed penalties of £750,000 on each of GLG and Philippe Jabre for market abuse, and for breach of Principle 5 - failing to observe proper standards of market conduct. The firm was also found guilty of breach

¹³ FSA PS 149 April 2003

of Principle 3 – failing to have in place proper systems and controls for the control of inside information where a trader was taken over the wall on a proposed issue.

In reaching its decision, the FSA found Mr Jabre's conduct to have been reckless, rather than deliberate. Contrary to Enforcement's original case, the FSA did not find Mr Jabre guilty of a breach of Principle 1 (integrity), and did not withdraw his status as an approved person.

The case has important implications for the rest of the hedge fund industry.

For funds themselves, the finding of market abuse against GLG confirms that the FSA treats it as a fundamental principle that firms will be held responsible for the conduct of its traders and senior staff. The FSA did not just charge GLG with breaches of systems and controls requirements. GLG was also charged with market abuse and ultimately held responsible for the conduct of its fund manager. If an individual trader or fund manager is said to have committed market abuse, the FSA will also seek to convict the firm of market abuse.

Civil Liability arising out of regulatory breaches

So far I have discussed only the regulatory consequences for investment managers who transgress rules or the market abuse provisions. But regulatory breaches may have serious liability consequences for the investment managers, which may become highly material if the fund is unable to repay its investors.

I have referred above to some of the regulatory provisions which are enforceable by the FSA by enforcement action, both against the investment managers as a firm and against senior management and other approved persons exercising a controlled function.

But that is not the only relevance of a potential breach of the FSA rules. Under section 150 FSMA individual private investors who suffer loss as a result of the contravention by a firm of FSA rules will in general have a cause of action in damages against the firm. That is not a provision that has been much invoked to date, but it is likely to assume more importance in the future. Perhaps surprisingly as the FSA moves to a regulatory system which is based much more on the Principles, rather than detailed rules in the handbook, section 150 does not permit investors to sue for breach of the Principles as such. Historically the Principles were introduced as very general statements of required behaviour under the earlier regime under the Financial Services Act 1986 and they were introduced on the basis that these general statements should not give rise to civil liability. I question whether that rationale continues to apply but the position clearly remains that at present the Principles are not actionable in themselves¹⁴. However in practice it is likely that a breach of the Principles will also be accompanied by a breach of detailed conduct of business or systems and controls rules, and if that is the case then an action would lie at the suit of investors who have suffered loss as a result.

I have made the point that market abuse is a regulatory offence, which empowers the FSA to impose an unlimited financial penalty but it is not directly actionable at common law or under section 150 of FSMA. However I do not think that is the end of the story.

Firstly where a regulatory investigation shows that an investment manager has engaged in market abuse, then it is very probable that there will have been some incidental breaches of FSA rules. For example, it may not be difficult to allege that the systems and controls of the investment manager were inadequate, so that there was a breach of FSA rules in this respect. A breach of those rules would be actionable under section 150. Secondly the FSA itself has power under FSMA to seek restitution for investors from the courts.¹⁵

Thirdly I would not discount the prospects of a successful claim in conspiracy at common law to commit the regulatory offence of market abuse. An agreement to rig the

¹⁴ FSA Handbook PRIN 3.4.4; SI 2001 / 2256

¹⁵ FSMA section 383

markets by the spreading of false rumours has long been recognized as unlawful¹⁶. There is at present an active debate in English law as to whether a claim in conspiracy by unlawful means may be founded on acts which are not themselves actionable in damages, but which constitute a crime or breach of statute. Judgment is awaited from the House of Lords in *Commissioners of Customs and Excise v. Total Network* in which the issue is directly raised, and if not decided before then it may be further considered in the case of *Mbasago v Logo* which is to be argued in February. The likelihood is that the House of Lords, notwithstanding its recent decision on economic torts in *OBG v. Allen* which appears to confine the concept of unlawful means to acts which are actionable, will decide that a claimant in conspiracy can rely upon any act which is unlawful as being prohibited by statute. If that is the outcome -- and I am not optimistic that my arguments to the contrary in the House of Lords will have succeeded -- then market abuse, which in general is founded upon a deliberate act of market misconduct would in most cases become actionable in common law under the tort of conspiracy.

So that any market participants or indeed an investor who could claim to have been damaged by the conduct allegedly constituting market abuse would have a claim in damages for conspiracy against the individual trader and the investment management firm which perpetrated the abuse.

Investors in a fiduciary capacity

In recent years it has become accepted investment orthodoxy is that pension funds should have a proportion of their assets invested in alternative investments, including hedge fund investments. The argument is based on the diversification of risk and the search for absolute returns, uncorrelated to conventional long only investments. Even the FSA has been recently persuaded by these arguments to consider allowing the marketing of investments in funds of alternative investment funds to retail investors¹⁷

¹⁶ *R v Berenger* 3 M&S 67; *Scott v. Brown* [1892] 2 QB 724

¹⁷ FSA CP 2007 / 06

Until recently these alternative investments were generally unavailable to trustees under English law, governed by the provisions of the Trustee Act 1961 which confined trust investments to specified kinds of lower risk securities and Victorian case law which required trustees to avoid investments "attended with hazard"¹⁸. The changes effected by the Trustee Act 2000 and the Pensions Acts 1995 and 2004 mean that trustees now have much greater discretion as to where to invest their funds.

The Pensions Act 1995 governs the investment decisions of pensions fund trustees only at a very high level of generality¹⁹. The pension fund is required to have prepared a statement of investment principles, and the trustees are required to have a reasonable understanding of those principles. Trustees are required to take advice, which must be confirmed in writing, on investment allocation decisions. Under regulations pension fund investments must consist predominantly of investments admitted to trading on regulated markets and derivatives may be used only to reduce risk. But the regulations say nothing about the constraints that should be applied to alternative investments, some of which may imply the same sort of risks as are involved in investing in derivatives.

The danger that I see in this is that the statute has opened the door to alternative investments by pensions fund trustees on behalf of their pensioners without the same sort of protections which apply where retail investors would wish to invest directly. There is a lack of symmetry between the operation of collective investment schemes – closely regulated by the FSA and which do not at present allow hedge fund investments²⁰ – and pension funds where trustees have a wide discretion to invest in any fund they consider appropriate. Pension fund trustees are not required to spread their hedge fund investments through funds of funds, in contrast to the regime proposed for collective investment schemes.

¹⁸ *Blyth v Falgout* [1891] 1 Ch 337 at 354; *Re Whiteley* (1886) 33 ChD 347 at 350, 358

¹⁹ Pensions Act 1995 sections 35 & 36; Pensions Act 2004 section 247; Regulations SI 2005 / 3378

²⁰ Although the FSA now appears ready to allow hedge fund investments but only in funds of funds and subject to constraints – CP 2007 / 06

Pension funds are likely to be substantial losers in any major fund insolvencies. We have already seen this in the Amaranth case²¹. The pension fund trustees may bring claims against the investment managers based on misleading valuation practices or the misrepresentation of risk. After the event it may not be difficult to make a case that the risk which caught out the manager must have been misrepresented to the investor.

But an issue which I would expect to arise, if it has not already, is how the trustees of a pension fund will be to justify after the event an investment in a fund which has proved to be a failed speculative enterprise.

It appears to be accepted that trustees should seek to achieve diversification of risk and that a limited proportion of their investments may be in higher risk investments, so that trustees may hold "modest holdings of high risk securities"²². This has led to the general acceptance that pension fund trustees may invest in alternative investments, including hedge funds.

Hedge fund investments are being marketed as absolute return low risk funds, but there have been some spectacular illustrations of how risk can be misunderstood.

Protestations by the investment managers – from Long Term Capital Management to Amaranth and Global Alpha - that they were caught out by a one in 200 years or a nine sigma occurrence should not carry much conviction -- more likely that something was wrong with the risk modelling and extreme events were much more probable than appreciated at the time.

Criticism may therefore be made of trustees who invest in hedge funds and lose their investments. There is clearly a theoretical case for alternative investment strategies and doubtless within the hedge fund universe there are some absolute return funds which can genuinely be viewed as low risk, but there also many that will prove to have misunderstood the risks of their strategies. The difficulty is the impossibility of knowing - from the outside - which is which.

²¹ *San Diego County Employees Retirement Association v. Amaranth Advisors LLC* USDC 2007 claim

²² Lewin on Trusts (18th ed) 35-65 citing an article by Lord Nicholls in 1995 9 Trust LI 71

There are I think a number of difficulties in justifying pension fund investment in hedge funds.

The first relates to the question of whether the investment actually serves to match the pension liabilities. The difficulty for trustees is in assessing, in the light of the lack of disclosure accompanying hedge fund investments, which funds will meet their investment requirements. In this field past performance is absolutely no guarantee of future returns and leverage must increase the risks as much as it increases the returns. It is not obvious that hedge fund investments serve as a particularly good asset match for the liabilities of a pension fund. Nor does there appear to be authoritative research, based on comprehensive data unaffected by survivorship and other biases, to the effect that the performance of hedge funds in general is uncorrelated to general market movements or that in this area diversification pays. Classic investment theory would suggest that chasing higher returns can only be done by incurring higher risk, even if that risk is not apparent.

It seems to me there is a systemic problem here. The opacity of hedge fund investment policies and the necessary commercial secrecy attaching to their actual positions make it particularly difficult for an outside investor to understand the risks being run in the fund or to carry out any form of due diligence.

The further point is the effective absence of legal recourse for the investor. The offering document will have been replete with risk warnings, the investment mandate is likely to be extremely wide and recourse to the courts will be excluded by an arbitration clause providing for arbitration in and under the law of a distant jurisdiction.

So to justify their investment decisions the trustees should be able to show that they received independent advice -- that is advice not from the hedge fund managers to whom they entrusted the funds -- and that that advice was based on sound investment theory. A board of trustees which relies on a sales pitch from the hedge fund, supported

by past performance figures of very limited utility, may find itself seriously exposed when the fund goes bust.

If one reads the complaint made in the Amaranth case by the investing pension fund the main question that immediately arises to my mind is how the fund agreed to invest in the first place on the basis of oral assurances as to the risks being run. The description of the strategies of the fund were at such a high level of generality that investment could really only be a leap of faith in the integrity and competence of the management.

A summary on the regulatory risks

In general hedge funds have had a very easy regulatory ride to date in the London market. Notwithstanding the vigorous public statements by the regulator of perceived abuses being perpetrated by investment managers, against the markets and against their investors, there has been only limited regulatory action. The *GLG & Jabre* case is the exception which illustrates the rule.

But one should not underestimate the speed with which the regulatory landscape can change after the occurrence of an investment disaster affecting retail consumers. A key driver for the regulator, and the politicians, is the protection of retail consumers. The FSA was largely brought into being because of the huge public disquiet at the inadequacy of the previous regulatory system in dealing with pensions mis-selling. The FSA endured its most severe test in dealing with the losses arising in split capital investment trusts. And Northern Rock shows how the fear of imminent consumer loss immediately captures regulatory and political attention.

So whilst the hedge fund industry attracts investments only from sophisticated investors who are capable of understanding the risks they are running, then the occasional default will not cause the regulator any loss of sleep. Any clear evidence of malpractice – after the event – will of course be picked up and prosecuted in order to protect the market

confidence objective. But the FSA does not regulate the hedge funds themselves and, even if it did, it does not operate a zero failure regulatory regime. Its role is not to prevent sophisticated investors from losing money.²³

But if there is a major loss in which a British pension fund takes a major hit then the call for stringent regulatory action will be very strong. And that may have serious implications for the investment managers concerned.

²³ Speech – Chief Executive of FSA 20 November 2007