Hedge Fund Regulation

With the meltdown in financial markets and the near collapse of the banking system last year**, hedge funds have come under increasing regulatory scrutiny**. Whether or not this is justified is another matter. There is certainly justification for more scrutiny and more useful regulation with the emphasis on the useful. Unfortunately the trend has been away from understanding the role and position of hedge funds in the financial system towards a reactionary approach towards regulating them.

It is fair to expect increased regulation as deeper and broader investigations are initiated into the financial crisis. This can be good or bad. **The hedge fund industry needs regulating.** It is the nature of that regulation that is in question. **Regulation should be driven towards providing investors with sufficient and adequate information to make informed investment decisions.** Investor protection needs to be measured lest it creates moral hazard, or creates unnecessary barriers to entry. The provision of information is by the few, the receipt of information is by the many. There are asymmetries of costs of free flow of information. Raising the bar in terms of disclosure and information can create barriers to entry which later encourage the type of concentration in the industry that was seen in the fund of funds industry which came to a head in 2008.

Regulation can be driven with the participation and cooperation of the hedge fund industry or it can be unilaterally established by regulators and imposed upon the industry. **It is in the interest of the hedge fund industry to actively engage regulators**to find a joint solution that will satisfy both the industry and the regulators alike. If we are lucky the solution might even satisfy investors. In any case, the complexity of the hedge fund industry means that regulators will need to gain deeper insight into hedge fund strategies and industry dynamics before they can even begin to contemplate policies.

The market is therefore self regulating in some respects. A 50% shrinkage in assets under management is clear evidence of investor driven policing. Yet this investor driven 'regulation' has come too late. The concentration of investor power in the hands of the funds of funds was an opportunity to reform the hedge fund industry, to encourage it in a more investor friendly direction. Instead little was done. With the investor community in as much distress as the hedge fund community, one can only hope that there remains enough left to reorganize and regroup, and to address those missed opportunities.

Investor demand for greater disclosure and transparency will increase. Investor's acceptance of inefficient terms and structures will diminish. Here is an opportunity for industry self regulation. Regulation, especially self regulation, should encourage the establishment of standards of disclosure and reporting. There should be no mandatory imposition of such standards, only the publication of such standards so that investors can price any deviation from these standards in their investment decisions.

Regulator driven standards is a likely reaction. **It is important that standards are not mandatory** since compliance or non-compliance provides useful information about the qualities of a hedge fund manager. Making something mandatory simply suppresses all that information. And some investors are more sophisticated than others. And investors all have different tolerances for risk.

as eligible investors is a likely reaction which I think is misguided. I have argued elsewhere the need for opening up the hedge fund industry to the retail market. There lies in this an opportunity for funds of funds to reinvent themselves to in a more relevant form to a new audience.

This is just one simple person's view. I would be interested in your views on what form should hedge fund regulation take and would love to hear from you on how would you propose hedge funds should be regulated.

Please go to the Forum on my website and make your views heard.