Regulation of hedge funds in Asia

The SEC and the FSA are some of the most sophisticated and well resourced regulators in the world. They have to be, they deal with the nice people over on Wall Street and the City. These days that's extended to Connecticut and Mayfair respectively. Yet the number of frauds and bad things that seem to happen in the US and UK in hedge fund land, while few and far between, compared with what happens in Asia, is relatively high. There will always be frauds wherever one looks but the incidence in HK and Singapore is just lower. I can only speak of the Singapore experience where regulation is actually rather light. The approach taken there is a balanced one requiring a full licence and regulation if the investment manager wishes to seek retail investors, and the exempt fund manager status, if one is targeting only professional investors or expert investors. It has been criticized for being too light with insufficient surveillance. In fact the Monetary Authority of Singapore is one of the most vigilant regulators. The MAS has already reacted to the financial crisis of 2008 and the ensuing frauds coming out of the woodwork (ex Singapore I should add) by reviewing its regulatory framework. Chances are, it will not have to tweak the current regime too much and it will use this opportunity to beef up the rules for more strategic and longer term considerations. The result will be, hopefully, a balanced framework which is commercially friendly and provides adequate investor protection while improving market efficiency and stability.

Back in school when we were reading economics we came to the subject of policing contracts. There were several scenarios and moving parts. Say you were trying to police illegal parking in a city, the variables you had to play with were the severity of the penalty and the probability of getting caught. The deterrent effect was increasing in the severity of the penalty and in the probability of getting caught, that much was trivial. But there was a cost associated with executing the penalty and catching the offender. The cost of catching the offender was high, you needed lots of traffic wardens roaming around town examining car parking labels and coupons. The cost of executing the penalty was low. You collected 50 bucks or whatever it was. So you had a bunch of traffic wardens wandering around town collecting 50 bucks for every car that was parked illegally. Now, for a fixed penalty, say 50 bucks, if you increased the number of wardens, you increased the probability of catching the perpetrators. As the probability approached 1, the cost of parking illegally approached 50 bucks, with certainty. But for a probability of detection of x%, if you varied the penalty, you also got some interesting results. For example, say you had 1 warden in the entire town, but he had a gun, and if he found an illegally parked car, he would wait for the driver to come back… you get the idea. The cost of offending could be made arbitrarily high. The number of repeat offenders is definitionally zero, and the signalling value to potential offenders is invaluable.