

In an analysis of the US and UK regulatory systems for hedge funds, the US could learn from the British example, argues Scott Wilson of IMS Consulting

A matter of choice

Something is seriously broken in the US regulatory system and one need look no further than the recent hedge fund rule fiasco for the evidence. Given that the Securities and Exchange Commission (SEC) has been in existence for over 70 years, just how long is it going to take to make the system work effectively?

In the UK, despite the regulatory system being relatively new, and despite the UK Financial Service Authority (FSA) having adopted many SEC rules and regulations, there exists a comprehensive, cohesive, effective and respected regulatory system. In the US on the other hand, the regulatory system is a shambles of political infighting, outdated laws, retrospective rule making, complex and confusing rules, a lack of guidance and, many would claim, a frequently heavy-handed inspection approach. It is an overly legalistic system lacking both consensus and clarity.

Take different legal paths

So why does the UK system of regulation succeed while the US system is in a state of turmoil? Where can the SEC look to the FSA for useful guidance?

It could begin with consensus on the regulation of hedge funds. Regulators everywhere generally agree on the purposes of regulation – to protect investors, ensure orderly markets and reduce financial crime. They start down the same path but move off in different directions. The UK government took the view that you can only achieve all of these objectives if you regulate every component company which may affect them. So every firm that conducts investment business has to be regulated. No exceptions. The US has a complex series of exemptions for smaller businesses but also

for many large businesses such as hedge funds. Hedge funds account for between 20% and 40% of all securities market transactions. Thousands of direct investors are unprotected as are millions of indirect individual investors, such as beneficiaries of retirement plans, who need protection the most.

The US has a partial regulatory system and the part that is regulated is growing smaller as hedge funds grow larger. It is partial because the laws defining who should be regulated are outdated (the Advisers Act 1940 did not foresee the growth of private funds) and a legislative change is required to bring them within the regulatory system. But as long as regulation is used as a political football, this task is likely to be a tough and drawn out process.

Even the SEC commissioners cannot agree on regulation. How can the country's senior regulators possibly present a rational case against hedge fund regulation? They are a huge part of the financial market and their investors a massive portion of the investor market. One may as well not regulate anyone west of the continental divide. Their weak arguments about lack of resources or hedge funds being adequately regulated under the anti-fraud provisions are nonsense. If the anti-fraud provisions themselves are adequate protection, why not allow every investment adviser to deregister?

In the rule-making process, the differences between the US and UK are particularly marked. The FSA drafts rules, issues detailed consultation documents and provides for a generally lengthy consultative process. When a rule is finalised, companies are given ample time to implement the rule. It is a considered and consultative approach and even if a new rule was not initially

welcome, the FSA usually has everyone on side when it becomes effective. The rule then goes into a rule book issued to all firms. It will be accompanied by written guidance, to provide additional interpretation and clarification and if there is still confusion, the FSA might hold workshops. It is a very effective process.

Lack of definition

The SEC has no rule book. Although there are some written rules, the SEC makes rules via a complex process of enforcement, no-action letters and even via speeches. Rules appear simply to develop over time, frequently causing mass confusion. The SEC's legalistic and cautious approach is not conducive to providing guidance and interpretation because it then ties the SEC to that guidance and removes the flexibility it needs to enforce the rule. A useful example is the email retention 'rule'. Millions of dollars are being spent developing systems to retain and sort every email. Firms are introducing prohibitions on the use of personal email accounts and instant messaging. The efficient operation of businesses is being disrupted because they are confused, lack guidance and fear enforcement by the SEC for failing to maintain records there is absolutely no requirement to keep.

Firms are simply required to comply with the 70-year-old SEC record-keeping requirements. If they keep some of those records in electronic form, then that is their choice and they should keep relevant emails. Side letters and anti-money laundering are other current topics of confusion. How can a regulatory system function properly if no one knows what the rule requirements are, whether they apply and, even if they



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do not apply, whether the SEC might nevertheless enforce them? All this detracts from the real job of compliance – developing, maintaining and monitoring high standards of business practice.

A question of inspection

The differences are also marked with respect to enforcing compliance via the inspection process. The FSA took little time realising that a bottom-up inspection process – spending weeks reviewing boxes of records – is both a drain on resources and frequently serves only to detect minor violations while revealing little about the bigger corporate picture and associated risks. A sample of 500 trading records at any hedge fund will reveal some form of deficiency. Of course they will, we all make mistakes. Mistakes do not make us crooks, they make us human. So the FSA focuses heavily on a top-down inspection approach, reviewing the structure and organisation of a business, assessing the strengths of management and their understanding and management of their business, operational and investment risks. It looks at the allocation of senior management responsibilities, to ensure all areas of the business are being appropriately monitored and controlled. It considers the reporting infrastructure and assesses the compliance culture. These are the matters of real relevance to the regulatory objectives.

It may sound anathema to US compliance officers but in 2001 when the FSA ceased its regular annual inspection programme of hedge fund managers, many of them complained. They

welcomed the inspection process – it gave them the opportunity to learn, to correct unidentified weaknesses. In the US, everyone lives in abject fear of an SEC inspection. The SEC frequently arrives unannounced and may sit for months trawling through records, disrupting management and, many would argue, appears hell bent on flushing out frauds which usually do not exist. And while the SEC ties up its resources trying to find that one bad allocation which will enable it to mete out some completely unreasonable financial fine or issue some aggressive deficiency letter, it is missing the big picture. How many inspectors were tied up inspecting the veins on the leaves of the branches of the trees while the market timing forest was on fire?

The FSA works with registrants, it consults with them and helps them comply. It encourages small firms to use external compliance consultants to advise them and perform regular internal compliance audits. It even advises and consults with the compliance consulting market. It has 'principles' rather than anti-fraud provisions because compliance with a principle is subjective and calls for a reconciliation with conscience or a reference to best business practice.

This encourages the development of high ethical and procedural standards. A breach of a principle is not necessarily a fraud. The SEC has anti-fraud provisions and when assessing whether an action amounts to a fraud, there is no recourse to corporate morals, only to legal opinion. Compliance with a principle needs good judgment. Compliance with anti-fraud requires a legal analysis.

In the UK compliance is primarily about protecting investors. In the US it is about protecting yourself. It is a legalistic system focused on liability management and has little to do with investor protection. Give companies the tools to comply and the time to comply and they will generally comply. The vast majority will strive for high standards of business practice and strong corporate ethics. But in an environment of fear, when everything you say, do or write has to be triple checked by lawyers in case it is deemed a fraud, the system is doomed.



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