

Hedge Funds and the FSA – Where's the Risk?

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Imagine for a moment the likely chaos on our roads if the DVLA suddenly decided that it would no longer require motorists to study the Highway Code, learn how to drive or pass both a written and practical test before they take to the roads. Instead, it would merely grant a licence and trust that drivers would be responsible persons and do all this of their own accord. It would still require high standards of driving knowledge and ability, but it would no longer test these standards. In order to get your licence, all you need do is apply and prove that you are a decent bloke.

Then imagine that once your driving licence was granted, there were no police or traffic wardens employed to enforce the Highway Code. How would we react? Would we voluntarily memorise our safe driving distances, opt to drive within designated speed limits, adhere to parking restrictions and refrain from honking the horn menacingly at octogenarian ladies tearing up the middle lane of the M3 at 28 mph on a summer Sunday. Well some of us might but personally I would head straight for the M3 for a serious dose of road rage.

So why then has the FSA effectively done the same thing in the financial services sector to hundreds of hedge fund managers? Prior to November 2001, every hedge fund management company setting up in the UK was visited by the FSA (or IMRO as it was then) immediately prior to being granted authorisation to test its preparedness to commence investment business. In addition, each was visited again within three months of authorisation to ensure adequate compliance procedures had been implemented and to assess the compliance

standards and risk to investors. Based on its inspection visits, the FSA would then determine when to return to perform a further inspection. In most cases, this was on an annual basis. In addition to all of this, it was also a condition of FSA authorisation that all new hedge funds retain the services of an external compliance professional to carry out quarterly independent compliance audits.

It is easy to see why (to my knowledge) no hedge fund manager was ever publicly disciplined for breach or disregard for the rules. Quite simply, the FSA kept them on their toes and as a result, the management and staff of hedge funds, whether they liked it or not, had little option but to invest adequate time and money in compliance.

Now move the clock forward a couple of years. Today there is no FSA policy or programme in place to visit hedge funds. Most of the two hundred or so hedge funds authorised since November 2001 were not visited before or at any time after authorisation (accepting that a small number have been subject to theme type visits). In addition, the FSA has ceased inspection visits to all of the hedge fund managers authorised prior to November 2001 and in addition the FSA no longer requires managers to retain experts to carry out compliance audits. Finally, the FSA has decided to categorise almost all independent hedge fund managers as what is known as Schedule D, the lowest risk grouping for regulated firms. In other words, more than £100 billion of assets is being managed in the UK by small teams of investment professionals who the FSA trusts to comply, without any expert

assistance whatsoever, with the largest and most complex piece of legislation and associated rules ever conceived and put on paper in the history of UK law. A not inconsiderable achievement given that many seasoned compliance professionals still find it difficult to negotiate through the thousands of pages of rules and regulations in order to identify those with a particular application to a specific type of business activity. Put another way, more than £100 billion is being managed by relatively new and normally small independent firms and the FSA has no idea whether any of these firms has the ability to even identify applicable rules let alone put in place adequate arrangements to ensure compliance and then to actually comply.

So what is the extent of the problem which has been created by the FSA's new relaxed approach? Well it would be my contention that there has been a material shift in compliance culture within small investment firms, and not just hedge funds, in the three years since the FSA announced the end of its visit programme and, with it, the end of any form of effective means of policing the hedge fund industry.

In the pre November 2001 days, high standards of compliance were seen as paramount. Newly established hedge fund managers would beauty parade the professional firms and compliance consultancies to determine the most experienced and appropriate firm to advise and help them implement and maintain such standards. Almost every firm in the sector either employed an experienced compliance officer, retained the services of an external compliance consultant or otherwise obtained ongoing compliance advice and

assistance from their lawyers or accountants. Professional advisors would compete on quality and experience rather than cost and the commitment to compliance was high.

Today, the story is somewhat different. Compliance budgets have been slashed to the point where many of the professional firms have ceased offering certain compliance services, such as assistance with the FSA authorisation process or ongoing advice and monitoring. The due diligence process performed on compliance consultancies by new start-up managers often does not get beyond a discussion of fees and business is too frequently won on cost alone.

Even the established managers, who lived through the tight regime imposed by IMRO, are letting their guard down. Despite many of these managers being three years more wiser, and in some cases much larger in terms of staff, assets and profits, compliance budgets have been reduced in absolute terms by as much as 60%. The impetus for this article, was in fact the discovery of an established manager whose budget for office cleaning was greater than their budget for outsourcing their compliance arrangements.

As memories of FSA inspection visits fade and the apparent lack of interest by the FSA becomes reinforced, firms are changing their view of compliance. If the regulator doesn't appear to care why should they? If the regulator accepts they have no compliance resource or expertise yet does nothing, why should they hire lawyers or consultants? If the regulator is not going to visit, then why

should it keep its books and records up to date when there are more pressing matters to deal with? If the FSA categorises all hedge funds as low risk, then why should the management of these funds spend time on detailed business risk assessments and organisational controls as the FSA rules require?

Many managers no longer perceive non-compliance as a material risk and consequently, compliance procrastination has become rife and in its worst form translates as wilful neglect. Quite simply, some managers are doing nothing whatsoever about compliance and do not even maintain the basic records. It is little short of astonishing that, with the unprecedented growth in the UK and European alternatives market and the rising tide of hedge fund crime (albeit almost entirely restricted to the US) that the FSA chooses to neglect this industry rather than to act to encourage higher standards and more compliant behaviour.

Many new hedge fund managers display a quite staggering lack of knowledge of compliance. And why shouldn't they. Many of them are ex prop traders who, for the past dozen years have worked in an essentially unregulated market dealing and managing the balance sheets of their international banking employers. These are often brilliant investment talents but other than understanding the need to manage conflicts of interest and maintaining dealing records, they have no knowledge of the bigger compliance picture or the broader aspects of the rules. Overnight they find themselves managing asset management companies small on staff but big on assets and revenues. They ignore compliance because they confuse

it with honesty and ethics. They assume that in the absence of fraud and malfeasance, compliance just happens. They make ridiculous statements such as "we don't do any PA dealing so what compliance is there?"

So where is this leading the UK's hedge fund industry? Well inevitably for some it will end in tears. Not because they were particularly doing anything mischievous but because they were not doing anything at all. The rules require things to happen and when the FSA finally wakes up and discovers they are not, it will take a few high profile scalps and puff out its chest whilst the guilty parties, somewhat ironically, will inevitably claim to be victims of a heavy handed regulatory approach and martyrs to the hedge fund cause. The rest of the industry will once again throw time and money at compliance and after a while the circle will repeat itself as it has so often over the past 16 years of regulation. Name an area of the UK financial services industry not to enjoy a major scandal in the past 16 years. The only one I can think of is hedge funds. But will they themselves act to prevent this. Why should they? In 27 years of driving, I have only been booked for speeding once yet probably every car journey I have ever taken or will ever take, I have or will break the speed limit at some point in the journey. Why, well I won't get caught will I, and if I do, I drive an estate and the three points and forty quid are not a great deterrent. The big fines and bans are always reserved for Porsche drivers!