

LEADER: Hedging risk

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Should **hedge** funds be sold more readily to retail investors and therefore be regulated more tightly? When so many investors are nursing burnt fingers and when **hedge** funds' short-selling is being blamed, wrongly, for stock price falls, it is a brave question to ask.

Britain's Financial Services Authority has asked it. Even better, it has provided a refreshing answer. Although the FSA wants a debate on the subject, it has made a convincing case for doing next to nothing.

There is no specific regulatory regime for **hedge** funds in Britain. In any case, most **hedge** funds are domiciled in offshore tax havens, beyond the reach of the FSA. But it does regulate the activities of UK-based **hedge** fund managers and the way **hedge** fund products are sold in the UK.

As unregulated products, **hedge** funds can only be marketed to institutions and to private customers who are deemed to have sufficient expertise and understanding. In practice, most **hedge** funds filter out all but the richest individuals with their minimum investment requirements, typically of \$100,000 (¥65,000).

Even if the FSA wanted to widen that elite club, it would not be easy. Bringing **hedge** funds within the remit of authorised products would require significant changes to UK regulations and conceivably to various European directives. UK-listed **hedge** funds might also have to change their investment practices, such as accepting limits on assets put at **risk** in short-selling.

Hedge funds would have to be subject to additional disclosure requirements so that retail investors were fully aware of the **risks** involved. But by their nature **hedge** fund products are highly complex, opaque and constantly changing under aggressive management.

There are legitimate concerns about transparency that should be addressed, whether or not **hedge** funds are to be sold more widely. For example, it is difficult for investors to know how much short-selling is taking place in any particular stock. Compulsory disclosure of stock lending would help.

The lack of proper surveillance of **hedge** funds is also a problem. Investment banks acting for **hedge** funds have a vested interest in their clients' solvency. Even so, regulators could force them to provide regular information about the activities and gearing of their **hedge** fund clients.

The paradox is that liberalisation of access to **hedge** funds requires more regulation. Given the unique role they play in managing **risk** and providing liquidity in falling markets, this might be too high a price to pay for providing greater choice for the small investor.