CONSULTATION REPORT

THE REGULATORY ENVIRONMENT FOR HEDGE FUNDS
A SURVEY AND COMPARISON

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANISATION OF SECURITIES COMMISSIONS

March 2006

This paper is for public consultation purposes only. It has not been approved for any other purpose by the IOSCO Technical Committee or any of its members.

Background information

In 1999, the IOSCO Technical Committee (TC) conducted a survey on the regulatory environment for hedge funds among its members. In late 2001 this survey was updated with a questionnaire on the extent of retail participation in hedge funds in the jurisdictions represented in the TC. A report entitled "Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds" (the "2003 TC Report") was published by IOSCO in February 2003 This paper identified specific regulatory issues created by hedge funds and detailed approaches for addressing the impact these issues have on retail investors.[1]

In February 2005 the TC mandated its Standing Committee on Investment Funds ("SC5") to update the 2003 TC Report by mapping the different approaches taken in each SC5 member jurisdiction to take account of any regulatory reforms in hedge fund regulation or in the concept of retail client as related to hedge funds. The results of this exercise will be used to assess if the TC should do additional work on hedge funds.

The international financial community is invited to submit comments on this Consultation Report. Specifically, the international financial community is asked if it agrees with how the TC perceived the trends as they are reported here.

After considering the comments received as a result of this consultation process, SC5 will submit a final version of the report to the IOSCO Technical Committee for consideration.

How to submit Comments

Comments may be submitted by one of the following three methods, at the latest on 31 May 2006. To help us process and review your comments more efficiently, please use only one method.[2]

1. E-mail

- Send your comments to Ms. Pamela Vulpes: p.vulpes@iosco.org
- The subject line of your message should indicate "Comment on Consultation Report on Hedge Funds Offered to Retail Investors".
- If you attach a document, indicate the software used to create the attachment.
- Please, do not submit attachments as HTML, PDF, GIF, TIFF, PIF, ZIP or EXE files.

[1] The 2003 IOSCO Technical Committee Paper was exclusively concerned with retail investor protection issues, and did not address systemic risk issues and banks' and investment firms' exposure to hedge funds.

[2] Important: All comments will be made publicly available, unless anonymity is specifically requested. Comments sent via e-mail will be posted on the IOSCO website. Comment s sent via fax or paper will be converted to PDF format and then posted on the IOSCO website. Personal identifying information will not be edited from submissions.

Or

2. Fax

Send your comments by fax to the attention of Ms. Pamela Vulpes at the following fax number: +34 91 555 93 68.

Or

3. Post

Send your comment letter to:
Ms. Pamela Vulpes
IOSCO General Secretariat
C/ Oquendo 12
28006 Madrid
Spain

Your comment letter should indicate prominently that it is a "Comment on Consultation Report on Hedge Funds Offered to Retail Investors"

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1. Executive Summary

In February 2005 the IOSCO Technical Committee mandated its Standing Committee on Investment Management (SC5) to update its report on "Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge funds" of 2003 (the "2003 TC Report"). SC5 was mandated to "seek to update the 2003 TC Report by mapping different approaches taken in each SC5 member jurisdiction to take account of any regulatory reforms in hedge fund regulation or in the concept of retail client as related to hedge funds."[3] The goal of this mandate was to see if any additional work on hedge funds should be done by IOSCO.

A questionnaire was designed to elicit responses covering all facets of these issues.[4] The questionnaire was composed of 29 questions, divided into seven separate areas. The seven areas addressed, among other things: strategies; definitions; registration; disclosure; advertising; reporting; examination; and disciplinary actions. Twenty SC5 members responded to the survey.[5] A chart summarizing the responses to the survey is attached to this report as Appendix C.

In brief, there are four significant conclusions to be drawn from these responses. Firstly, none of the responding members has adopted a formal, legal definition of the term "hedge fund." A chart summarizing survey responses relating to how members define or identify hedge funds is attached as Appendix D. Secondly, hedge fund advisers[6] are regulated in most of the responding jurisdictions. Thirdly, few jurisdictions report any significant "retailization" of hedge funds at this point in time, but some regulators anticipate that this is changing or may change in the future. Fourthly, there have been some incidents of fraud relating to hedge funds in the responding jurisdictions, with the extent of fraud low in some jurisdictions but varying in member jurisdictions. In addition, some members noted that their regulatory regime for hedge funds was new and that as a result, there was no data on hedge fund fraud. Member jurisdictions continue to monitor for fraud in connection with hedge funds.

Significantly, there have been developments of interest in terms of how hedge funds are regulated in many jurisdictions since the publication of the 2003 TC Report. The way that member jurisdictions are regulating hedge funds differ and many jurisdictions are still developing their regulations. In most of the responding member jurisdictions, hedge fund advisers are, or soon will be, regulated. Some member jurisdictions prefer to regulate the adviser to the hedge fund, rather than the fund itself. Many member jurisdictions regulate both the hedge fund adviser and the hedge fund. Various member jurisdictions regulate the

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[3] Appendix A, SC5 Hedge Fund Survey Mandate, February 2005.

[4] Appendix B, SC5 Hedge Fund Survey, March 2005

[5] The 20 responding SC5 members are securities and/or financial regulators from the following jurisdictions: Australia; Brazil; Canada-Ontario; Canada-Quebec; France; Germany; Hong Kong; Ireland; Italy; Japan; Jersey; Luxembourg; Mexico; Netherlands; Portugal; Spain; Switzerland; United Kingdom; United States (CFTC); and United States (SEC).

[6] The term of adviser means a person or an entity which manages a specific portion of the hedge fund's assets.

distribution of hedge funds, and/or the information that the hedge funds provide to customers, and/or information provided to regulators regarding fund finances. These various forms of regulation are worth reviewing more precisely.

2. Hedge Fund Questionnaire 2005

The questionnaire, which was completed by 20 SC5 members, sought member updates in seven distinct areas in relation to various aspects of hedge fund regulation, including:

A. *General background information*: Estimates regarding the number of hedge funds and amount of assets under management; and identifying the hedge fund strategies which are being used/offered.

B. *Definitions*: Definitions of the term “hedge fund,” and any differentiation from other types of funds, such as “collective investment schemes” (CIS), “private equity funds,” “venture capital funds,” and “futures funds;” and differentiation between hedge funds which are single strategy funds and fund of hedge fund operations ('FOHF').

C. Regulatory Approaches to hedge funds and hedge fund advisers: The nature of regulation of advisers and hedge funds themselves; whether registration of hedge funds and their securities is required; restrictions on hedge funds' activities; requirements for listing of securities; and advertising of hedge funds.

D. *Sales Qualifications/ Sales Restrictions*: Licensing requirements for representatives of brokers/dealers for retail-offered funds; and other restrictions on the sale of hedge funds.

E. *Retail Hedge Fund Disclosure*: Whether an offering memorandum and minimum disclosure must be provided to retail investors; whether hedge funds must disclose investment limits, leverage, etc.; and whether warnings are required.

F. *Retail Hedge Fund Reporting Requirements*: Periodic and annual reporting and disclosure requirements regarding investment performance and underlying investments; valuation issues; and prime broker arrangements regulation.

G. *Examination and Enforcement*: Examination cycle of hedge funds and advisers; customer complaints received; and administrative and regulatory actions and civil lawsuits taken against hedge funds, and other problems encountered.

The questionnaire is attached to this report as Appendix B.

3. Questionnaire Results

The responses of SC5 members to the questionnaire are broadly summarised below. A chart with a more complete aggregation of individual responses is attached to this report as Appendix C.

A. General background information

While information on the number of hedge funds/assets under management is still fairly limited, it is estimated that there is over US$1 trillion in hedge fund assets under management worldwide, with the vast majority of hedge funds and managers reported by the USA and the United Kingdom (although the entities may be domiciled offshore). (Appendix C, p.1.) It is noted that the data gathered from the questionnaire responses is difficult to compare or accumulate since jurisdictions identify hedge funds differently and the data can be difficult to obtain to the extent such funds are unregulated. As indicated, many jurisdictions do not have information about funds that make offers to professional investors or only make offers to people overseas (even though they might 'operate' in a particular jurisdiction). Certain jurisdictions, such as the USA (US-CFTC), Hong Kong, and Australia, where hedge funds fall under the authority of the regulator do have detailed information regarding the nature and activity of registrants that operate, sponsor, or advise hedge funds.

While comparison of the questionnaire results is still very difficult because of the lack of a universally accepted definition, it is possible to draw some broad observations about hedge funds from the questionnaire results. A method that could be used to analyse hedge funds is based on the scope and nature of the regulation that a jurisdiction applies to a particular hedge fund structure because, in some instances, the regulatory approach of one jurisdiction is similar to that of another jurisdiction.

B. Definitions

No surveyed jurisdiction has a comprehensive, legal definition of "hedge fund." (Appendix C, p. 3, Question 3.). The 2003 TC Report suggested an approach to defining hedge funds by looking at the characteristics of and the strategies employed by entities that would consider themselves to be hedge funds. The 2003 TC Report described hedge funds as having at least some of the following characteristics:

- Borrowing and leverage restrictions, which are typically included in CIS regulation, are not applied, and many (but not all) hedge funds use high levels of leverage;
- Significant performance fees (often in the form of a percentage of profits) are paid to the manager in addition to an annual management fee;
- Investors are typically permitted to redeem their interests periodically, e.g., quarterly, semi-annually or annually;
- Often significant "own" funds are invested by manager;
- Derivatives are used, often for speculative purposes, and there is an ability to short sell securities;
- More diverse risks or complex underlying products are involved.

The questionnaire responses indicate that the list of hedge fund characteristics from the 2003 TC Report has grown or expanded. Some members indicated a diversity of investment strategies associated with hedge funds, including emerging markets strategies, fixed income arbitrage, and a variety of other strategies which do not focus upon investment strategies using leverage effects or borrowing.

C (i). General Regulatory Approaches to Hedge Funds

Since the publication of the 2003 TC Report, there have been significant regulatory developments in many jurisdictions of SC5 members relating to hedge funds, including funds of hedge funds. Based on the questionnaire responses, it has been possible to identify at least three different general regulatory approaches to hedge funds.

Some jurisdictions accommodate more than one type of entity within their definition of hedge funds. Those jurisdictions apply different regulatory approaches that depend on certain characteristics of the fund, including retail participation and investment strategies. By grouping vehicles according to the regulatory approach of the regulator, the TC may be able to more effectively compare and analyse information about hedge funds.

1. Registered or authorized CIS engaging in hedge-fund like strategies

Most jurisdictions allow registered or authorized CIS to engage in hedge-fund like strategies (including funds of hedge funds):[7] *See* Appendix D. For example, some members have a specific category of CIS to accommodate CIS that engage in hedge fund-like strategies. In Brazil, while there is no formal definition of hedge fund, there is the "multi-markets" category of funds which is most similar to hedge funds since such funds are defined as having an investment policy that involves various risk factors. In Germany, there are funds with additional risks and funds of funds with additional risks. In Portugal, there is a special investment funds category.

The investment limitations imposed on these hedge funds vary from jurisdiction to jurisdiction.[8] For instance, Portugal and the USA impose different limitations on the use of derivative instruments. France imposes limits on leverage, while in the Netherlands and Germany (for single hedge funds) there are no restrictions as to leverage. In Germany leverage may not be used in fund of hedge funds. In Hong Kong, the Securities and Futures Commission ("SFC") considers that quantitative investment and borrowing restrictions may stifle the investment operations and flexibility of such funds in view of the divergent investment strategy and instruments utilized by hedge funds. Hong Kong hedge funds guidelines, therefore, follow a "disclosure" approach. In connection with funds of hedge funds, some jurisdictions limit the fund's maximum exposure to any single hedge fund and require a minimum number of underlying hedge funds (*e.g.*, Hong Kong, Jersey).

Jurisdictions also have differing approaches concerning retail participation in those CIS. In Ireland, only funds of hedge funds may be offered to retail investors. In Jersey, hedge funds may not be marketed to the general public. Some jurisdictions impose minimum subscription thresholds or other limits relating to retail participation in the fund. For instance, in Italy, where hedge funds cannot be marketed through public offerings, sales are restricted to "informed" investors who are able to pay a minimum amount of EUR 500,000 for each subscription. In Hong Kong, both single hedge funds and funds of hedge funds may be offered and sold to retail investors with minimum subscription thresholds and compliance with the SFC hedge fund guidelines, although privately offered hedge funds are not subject to SFC's product regulation. In France and Portugal, a hedge fund-like CIS must impose minimum subscription or net worth requirements on investors. In

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[7] It also is important to note that both Spain and Mexico are developing new rules for hedge funds that may allow the funds to register as CIS.

[8] For purposes of this paper, CIS that are so registered or authorized are viewed as hedge funds. A particular jurisdiction may not view such CIS as hedge funds in other contexts. For instance, under Swiss law a CIS may not identify itself as a hedge fund. As another example, the staff of the Securities and Exchange Commission of the USA, may not view registered funds of hedge funds as "hedge funds" because those CIS are subject to regulation as CIS.

Ireland, even though no category of CIS is authorized as a hedge fund *per se*, such CIS may be established for distribution solely to professional investors[9] and qualifying investors.[10] In contrast, the Netherlands and Brazil do not apply such requirements to the sale of those CIS.

2. Limited hedge fund oversight by regulator

Two jurisdictions subject certain hedge funds to limited oversight by and/or jurisdiction of the regulator but do not register or authorize the funds. Specifically, in Australia, this includes some small-scale funds that are not professionally promoted. In France, contractual funds file with the Autorité des Marchés Financiers ("AMF"), but do not request registration or authorization from the AMF. In these jurisdictions, the hedge funds are not subject to the investment limitations of ordinary CIS. However, Australia imposes certain prohibitions against offering them to retail investors, and France imposes minimum subscription thresholds and net worth or professional advice requirements on these types of funds.

3. No registration or regulation of hedge fund

Some jurisdictions have privately offered hedge funds that are not subject to registration or regulation by the regulator, such as the UK, where the funds are not registered (only hedge funds managers/advisers are authorized and regulated). *See* Appendix D. Such jurisdictions impose limitations on the public offering of these funds, or otherwise restrict retail participation in the funds. In those jurisdictions, the hedge fund may be subject to anti-fraud provisions, and the hedge funds adviser may be subject to regulatory oversight or anti-fraud enforcement. Although the private hedge fund is not registered or authorized, there may be an indirect regulatory impact on this type of hedge fund if the hedge fund manager is regulated (*e.g.*, USA, Ontario).

C (ii). Regulatory Approaches to hedge fund advisers

In many member jurisdictions, hedge fund advisers are now, or soon will be, subject to regulatory oversight. In most jurisdictions (18 out of the 20 survey responses) advisers of hedge funds are regulated or authorized like any investment adviser located in their jurisdiction (Appendix C, p. 4, Question 7.). There are exceptions: Luxembourg indicated that hedge fund advisers are not separately registered or authorized. Rather, the manager is accepted within the framework of the hedge fund (or CIS) for which they intend to act.

Some jurisdictions have special requirements for hedge fund advisers or subject the registration/authorization applications of such advisers to a different type of review. For example, in Italy, the management of hedge funds and funds of hedge funds is reserved to asset management companies whose sole activity consists of managing hedge funds. Criteria for licensing such companies in Italy include competence to carry out the functions and duties. In Luxembourg, during the process of CIS registration, investment

[9] A professional investor fund ("PIF") must impose a minimum subscription of EUR 125,000 and can avail of increased flexibility in relation to investment and borrowing parameters compared to retail CIS.

[10] A qualifying investor fund ("QIF") must impose a minimum subscription of EUR 250,000 and must meet qualifying criteria in relation to net worth. Regulatory limits in relation to investment diversification and borrowings are not applied.

advisers to CIS adopting alternative investment strategies (or hedge funds) must prove that they have the appropriate level of expertise in the investment policy of the CIS. In Hong Kong the licensing requirements are the same for all CIS advisers. However, when assessing any license application, the SFC considers factors such as the risk management system, target clientele and proposed business activities of the applicant and may impose appropriate licensing conditions if necessary (*e.g.*, managers of privately placed hedge funds will not be allowed to service retail investors). Quebec has specific proficiency requirements for investment advisers and representatives of the adviser. For example, representatives of an adviser acting as an adviser in derivatives must have a minimum number of years of relevant experience in derivatives.

D (i). Sales through Intermediaries

In the jurisdictions of SC5 members, the intermediaries who sell hedge funds are generally regulated, although there may not be 'hedge fund specific' requirements that apply to them. In Ontario, registered representatives who sell commodity pools must meet additional proficiency requirements.

D (ii). Advertising

Consistent with the general regulation of CIS, the advertising of hedge funds is generally regulated, or, in some cases, entirely prohibited (such as in the United Kingdom). In the Netherlands, for example, all licensed CIS, including licensed hedge funds, are allowed to advertise. In Hong Kong, too, authorized hedge funds are permitted to advertise. In Germany, public marketing is restricted to funds of hedge funds and prohibited in the case of single hedge funds. Several jurisdictions also permit the listing of hedge funds on securities exchanges. *E.g.*, Australia (subject to compliance with market rules); Brazil; Luxembourg; Netherlands; Ireland (even though it is not possible to offer hedge funds to retail investors). (Appendix C, question 12.)

E. Retail Hedge Fund Disclosure

Generally, offers to retail clients (where allowed) must comply with minimum disclosure requirements set out by law. In 11 of the 20 responding members, disclosure for retail hedge fund offerings can be subject to heightened disclosure such as a requirement for specific warnings. (Appendix C, p. 5, Question 18.) For example, in Brazil, CIS that invest in derivatives must include certain legends on the cover of their prospectus. Germany, too, requires specific warnings for the sales prospectus of single hedge funds and funds of hedge funds. France also has specific disclosure requirements, including warnings to be inserted in the prospectus of certain types of CIS that engage in hedge fund-like strategies.

F. Retail Hedge Fund Reporting Requirements

In many SC5 jurisdictions, as for other CIS, regular reporting (annual or semi-annual reports) is required to be provided for regulated hedge funds. (Appendix C, p. 6, Question 19.) Regular performance reports are generally required and are usually filed with the regulator. Switzerland has specific disclosure requirements for funds of hedge funds and their underlying investments. In the USA., special reporting for commodity pools also may apply to hedge funds. In Hong Kong, in addition to having to publish annual and semi-annual reports, authorized retail hedge funds have to prepare quarterly reports and must follow the SFC's guidelines for hedge funds that detail the minimum information required in these reports. In Germany, in contrast to other CIS, hedge funds are not required to disclose daily positions (but are, of course, still subject to regular annual and semi-annual financial reporting). (Appendix C, p. 6, Questions 20-22.)

As for any other CIS, asset valuation issues do arise in hedge funds from time to time; five members reported issues or developments in this area. For example, the USA-SEC reported some problems with improper valuation of hedge fund assets. Australia indicated valuation and unit pricing issues had been considered and that it anticipated issuing guidance for all CIS on this topic. The U.K indicated that it had encountered problems with valuation for hedge funds but noted such problems were outside their jurisdiction as the fund operators and administrators were offshore (Appendix C, p. 6, response to Question 23.a.)

Eight of the surveyed jurisdictions have a valuation methodology policy for hedge funds managers. For example, France has a regulatory framework for valuation of assets by CIS based on two principles: (1) the CIS must be able to assess valuation of an instrument independently from its counterparty and (2) the CIS must have a process to validate and control the models used by the CIS. In Germany, the custodian bank has a controlling function in the calculation of the unit value, inasmuch as the value is calculated either by the custodian bank with the assistance of the investment management company or by the investment management company itself. (Appendix C., p. 6, response to Question 23.b.)

In addition, it is interesting to note that some jurisdictions have a specific regulatory framework or requirements for prime-brokerage (*e.g.*, France, Germany, Hong Kong, Switzerland, UK, USA).

G. Examination and enforcement:

Some jurisdictions indicated that the number of enforcement actions or complaints relating to hedge funds was not high. (Appendix C, p.7, Question 26 and 27) The data on the level of complaints and enforcement actions involving hedge funds was difficult to compare due to the different perceptions of "hedge fund" and the varying regulatory treatment. Some jurisdictions have new regulations so enforcement data is not available (e.g., there were no on-shore hedge funds prior to the new regulations). Other jurisdictions do not separate enforcement data by type of CIS so no enforcement data relating to actions involving hedge funds was available. Other jurisdictions indicated enforcement actions or complaints relating to any regulated CIS are generally low in their jurisdiction. Switzerland reported actions involving offshore funds. As explained above, most members provided limited statistics on lawsuits involving hedge funds. Most hedge funds (i.e., those that are registered or authorized as CIS) and advisers are subject to audits by their regulator, including during the registration or licensing process. (Appendix C, p. 7.)

4. General Observations from Survey Results

1. While there is no formal legal definition of the term "hedge fund" in any SC5 jurisdiction, each jurisdiction has viewpoints of what a hedge fund is. Based on those viewpoints, SC5 observed common regulatory approaches to hedge funds among member jurisdictions based on broad similarity in these approaches. The groupings of

common regulatory approaches may allow the TC, in any future work relating to hedge funds, to collect and analyse data more precisely.

2. Some jurisdictions are developing regulations that are specifically for hedge funds that are registered or authorized as CIS. Moreover, even though in many jurisdictions some hedge funds may not be regulated, those who operate, sponsor, or advise on hedge funds are subject to regulation in many instances (or soon will be). In addition, regulations regarding disclosure, advertising, recordkeeping and reporting may be applicable.

3. Few jurisdictions reported any significant retailization of hedge funds at this point in time. However, this snapshot of current data should not be used to extrapolate future trends; some regulators reported that they anticipate greater retailization in their jurisdictions in the future.

4. The extent of fraud relating to hedge funds varies in the member jurisdictions (including among the types of hedge funds such as private hedge funds versus registered hedge funds). The absolute number of fraud complaints is presently not high although some regulators perceive a risk of greater fraud in the future as further retailization occurs. However, in this respect it is important to be mindful that the collected data represents a "snapshot" of the present time. Surveyed member regulators continue to monitor for fraud in connection with hedge funds.

5. Possible future work

Additional work in certain areas could be considered by the TC, for example, on the issues of permitted investment strategies for retail CIS, registered fund of funds, valuation and risk rating.

Consistent with prior work, common investor protection principles for hedge funds should focus on the need:

1. to ensure there is clear, concise and effective disclosure of the features of the hedge fund (e.g., fees; risks; experience of fund managers; internal controls, performance disclosures; conflicts of interest; fund of hedge fund issues; etc.); and/or

2. to develop principles around valuation issues (on the assumption that unit pricing errors may have an impact on the interests of investors in the fund more generally).

Appendix A
Hedge Fund SC5 Mandate

Hedge fund statistics

Hedge funds are one of the fastest growing asset classes. The number of hedge funds was estimated to be 8,100 at end 2003 compared with approximately 6,000 in 1998. The amount invested in hedge funds globally has increased significantly from around 300 funds managing around US$ 50 billion in 1990 to more than 4,000 funds managing over US$500 billion in 2002. In the last five years alone, hedge fund assets have grown 260 percent.[11] Assets under management among hedge funds were estimated to be over $800 billion at end-2003. Some predict that the amount of hedge fund assets will exceed $1 trillion by the end of the 2004 calendar year.[12] Although hedge funds have until recent years been disproportionately focused on attracting US investors, there has been a strong influx of funds targeted at the European and Asian markets.[13]

In the USA, the growth in hedge funds has been accompanied by a substantial and troubling growth in the number of hedge fund fraud enforcement cases – mostly involving hedge fund advisers. Hedge fund advisers were also key participants in recent scandals involving late trading and inappropriate market timing.[14]

The dramatic growth in hedge fund products (both single manager and fund of funds) has generated regulatory debate and attention across jurisdictions.[15] The regulatory environment for hedge funds differs in each jurisdiction.[16] Traditionally hedge funds have been promoted to wholesale investors. However, in some jurisdictions (where permitted by the domestic regulatory regime) hedge fund managers (including both large asset managers and boutique funds) are starting to market hedge funds to retail investors. Minimum investment requirements are decreasing, making hedge funds more accessible to retail investors. Increased retail investor interest can perhaps be partly explained by the poor performance of equity markets in recent years and partly due to retail investors increased appetite for alternative investments aimed at diversifying their investment portfolio. It must be acknowledged that investor interest may change, however, as global equity markets recover and prosper.[17] However, a growing number of pension funds are also investing in hedge funds as alternative investments. This increases the exposure of their beneficiaries to losses resulting from hedge fund investing.[18]

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[11] SEC Release No IA02333 Registration Under the Advisers Act of Certain Hedge Fund Advisers
[12] Ibid
[13] One source reports that assets in the European hedge funds industry increased by 20% in 2001 to reach a total of US$64 billion – EuroHedge Directory (2002)
[14] Above n 1
[15] That said, the number of combined CFTC-SEC (USA) enforcement actions involving hedge funds and commodity pools over the fiscal years 1999-2003 was just 3%. Most fraud was committed by unregistered entities, involving outright misappropriation.
[16] Ireland Switzerland Australia and Hong Kong expressly permit participation of retail clients in hedge funds.
[17] Figures for the current year to date indicate that hedge fund performance may be modest, gaining just 1.9.percent to the end of September. This is consistent with the counter-cyclical nature of hedge fund investing – when stock markets are up, hedge fund performance tends to be down.
[18] In Australia a pension fund with less than $10 million in net assets is considered to be a retail client.

Proposed SC5 Mandate

At the November 2004 TC meeting it was proposed that SC 5 should consider a mandate on hedge funds offered to retail clients, but there were differences about the scope of the mandate and concerns about the definition of 'hedge fund', in particular as to whether the definition would include 'fund of funds'.

It was noted that hedging as a strategy is an acceptable way of managing certain risks. *The mandate will not consider hedging strategies generally.*

It was also noted that exposure to hedge funds may be acceptable for retail clients as part of a diversified portfolio. Hedge funds have produced strong out-performance in recent years without incident in many jurisdictions. There seemed to be a consensus that the offer of hedge funds to retail clients (either single manager or through a fund of fund) should not necessarily be prohibited, but rather that it is the complexity of the product and the difficulty in understanding the risks entailed in the product that are problematic. Hedge funds have unique features, increasing the likelihood that consumers may invest based on misconceptions. Because hedge funds are often marketed as offering returns independent of market movements, they can seem an attractive investment alternative, particularly when returns on traditional investment products are expected to be low or even negative. However consumers may not appreciate the inherent risks in hedge fund strategies or the relatively high fee levels. Small boutique managers may also lack the skills to sustain performance of these alternative strategies.

It is therefore proposed that the SC5 mandate should seek to establish some common investor-protection principles where hedge funds or funds of hedge funds are offered to retail clients. This work should build on the IOSCO paper published in February 2003 *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds* (the '2003 TC Report')

Features of Hedge Funds

There is no single definition of a hedge fund. The population of hedge funds includes a diverse range of funds, ranging from a long/short equity fund to a convertible arbitrage fund. Some hedge funds are called absolute return funds because the fund manager aims to make returns independent of market conditions.

A hedge fund is a collective investment scheme (CIS) commonly recognised as an alternative investment product because of the management style employed and the types of risks adopted within the investment strategy. Generally hedge funds are flexible in their investment strategy – they can take long and short positions, use derivatives for speculative purposes and use leverage to gear assets. In addition to buying assets in the hope that their value will rise, hedge funds may use short-selling strategies that rely on an asset decreasing in value. Hedge funds may also borrow money to leverage their assets and gear their positions. These factors make the investment strategies of hedge funds more complicated than those of traditional CIS. Hedge funds usually adopt an active investment style. Therefore the skill of the hedge fund manager is highly important to the performance of the fund. Hedge funds often charge performance-based fees as a result.

A common type of hedge fund is a 'fund of funds'. A 'fund of funds' does not pursue alternative investment strategies itself, but instead invests in a number of different underlying hedge funds to spread risk across these funds. The overall performance of the 'fund of funds' depends on the individual performance of each underlying fund. Investors rely on the expertise of the fund of funds manager to pick a combination of hedge funds, as well as the skills of the underlying hedge fund managers. The fee structure of a fund of funds means that there are fees paid to both the fund of funds manager and the underlying fund managers. This means that a fund of funds must outperform a single fund manager in order to generate the same return to investors.

Proposed coverage of hedge funds – the mandate should cover single manager funds and fund of funds that predominantly use alternative investment strategies to generate returns where these funds are offered to retail investors.

Scope

Simplistically there are a number of regulatory approaches that could be adopted:

1. Express authorisation/registration of hedge funds offered to retail clients– this is the approach adopted by the Hong Kong SFC. This approach seeks to clearly set out the qualification requirements of a hedge fund manager, recognising that they require unique specialist skills to those required of traditional managers.

2. Prohibition of hedge funds offered to retail clients- this is the approach adopted by the FSA (via restrictions on leverage, derivatives, short selling and types of financial instruments that may be held by a CIS offered to retail clients, rather than by outright banning). This approach seeks to control product features (and thus contain the impact of any collapse of a highly leveraged fund).

3. Increased disclosure requirements for hedge funds offered to retail clients – this is the approach adopted in Australia. This approach seeks to redress consumer misconceptions through clear and prominent disclosure of the significant features of the fund.

Proposed scope – the mandate should seek to update the 2003 TC Report by mapping the different approaches taken in each SC5 member jurisdiction to take account of any regulatory reforms in hedge fund regulation or in the concept of retail client as related to hedge funds. The position of retail hedge funds could be contrasted with that of institutional hedge funds. Based on this survey update it may also be possible for the mandate to develop definitive guidelines for the regulation of hedge funds, eg by establishing clear disclosure principles for hedge funds offered to retail clients. These principles might cover various matters identified in the 2003 TC Report, such as:

- **Trading and investment strategy**: What is the fund’s trading strategy and how does it hope to generate returns? What financial products does the fund invest in? If the fund is a “fund of funds” what information should be given about the underlying hedge funds that will make up the total investment? This may include information about the selection criteria, risk profiles and due diligence performed on the underlying funds.

- **Investment risks**: What are the specific risks associated with this strategy and, in particular, how much leverage will the manager use?

- **Fund performance**: How does the fund manager measure the performance of the fund? How does the investor know whether the fund is performing well or badly?

- **Risk measurement :** How does the fund manager measure the risks supported by the fund? How does the investor know whether the risks supported by the fund are managed well or badly?

- **Valuation**: How are the investments of the hedge fund valued? What is the frequency of the valuations?

- **Fees and charges**: What fees are charged to invest in the fund? (This should include the effect of all fees, particularly performance-based fees and the fees payable to underlying managers in a fund of funds structure.)

- **Disclosure**: What ongoing information will the fund manager provide – it should be adequate to enable the investor to keep track of the fund's performance. It should also be relevant to assess the ability of the investors to understand to strategy led by the fund.

- **Exiting**: How liquid is the fund? Are there any penalties for withdrawing your money? (Many hedge funds have a long-term investment horizon. Therefore, exiting the fund after a short period of time may have a negative impact on the investor).

- **Warnings:** Should there be a requirement for a clear and prominent warning to alert investors to the special features and risks of hedge funds?

- **Compliance and Risk Management:** What types of compliance and risk management controls and procedures does the fund have in place for: compliance with securities laws, rules and regulations, risk management of trading strategies, trading positions, leverage, derivatives etc? Who are the people responsible for compliance and risk management and what are their responsibilities?

- **Outsourcing**: What reliance is placed on the skills of service providers and how is their expertise assessed and monitored?

- **Market Intermediaries (Custodian/Depository and prime-broker):** What type of functions are fulfilled by market intermediaries in regard to hedge funds? Do they provide custodial/depository or brokerage services for hedge funds? What are their contractual/statutory responsibilities and obligations?

Output

It is proposed that SC5 would produce a preliminary report updating the registration, disclosure and competence requirements of SC5 jurisdictions. It may then be possible to agree broad regulatory principles for hedge funds offered to retail clients.

Timing

An initial survey of SC member updates could be circulated for discussion at SC5's February meeting.

Appendix B :

Survey Questionnaire

General Background Information –

1. Please provide an estimate regarding the number of hedge funds in your jurisdiction and estimate the amount of assets under management.

	Number of funds	Assets under management (in USD Bln)
Registered hedge funds		
Offered but not registered hedge funds		
Operated but not distributed hedge funds		

Please provide details regarding private funds vs publicly offered funds and the fund of hedge funds (FOHF) v. single strategy funds.

2. Please identify the hedge fund strategies which are being used/offered in your jurisdiction.

   A. Convertible Arbitrage ___
   B. Event Driven ___
   C. Fixed Income Arb ___
   D. Long/Short Equity ___
   E. Emerging Markets ___
   F. Global Macro ___
   G. Managed Futures ___
   H. Dedicated Short Bias ___
   I. Fund of Funds ___
   J. Alternate Approaches ___

   For a brief description of hedge fund strategies see www.hedgeindex.com

Definitions-

3. Does your jurisdiction define the term "hedge fund"? If yes, please provide the definition.

4. Does your jurisdiction's definition of the term "hedge fund" differ from its definition of the term "collective investment scheme"?

5. Does your jurisdiction distinguish between “hedge funds”,“private equity funds,” “venture capital funds”, and “futures funds” or are they all grouped together. If your jurisdiction has definitions for “private equity funds,” “venture capital funds” and “futures funds” please provide those definitions.

6. Does your jurisdiction distinguish between hedge funds which are single strategy funds versus fund of hedge fund operations. If so, please provide your definition of “fund of hedge funds” (FOHF).

Adviser Regulation/Fund Regulation/Securities Regulation

7. Does your jurisdiction regulate the Adviser to a hedge fund? The term Adviser means a person or entity which manages all or a specific portion of the hedge fund’s assets. For a FOHF, the Adviser would be the person or entity who is responsible for evaluating, selecting and making allocations to the funds which the FOHF invests in. Please discuss whether you require “registration” of the Adviser or whether you merely require such Advisers to meet certain requirements to be in the business, e.g.; educational experience, professional degrees, specific licenses, no fraud convictions in last 10 years, etc.

8. If your jurisdiction regulates or registers the Adviser, please discuss whether the requirements are different for Advisers which advises funds offered to general public versus those which only advise privately placed hedge funds offered to institutional investors.

9. Does your jurisdiction regulate or authorize the hedge fund itself? Does it require “registration” of the hedge fund?

10. How does your jurisdiction regulate or authorize such funds? Please describe any restrictions on a hedge fund’s activities – leverage, short selling, derivatives, etc. Are hedge funds offered to retail investors required to be “registered” and reviewed by regulators prior to their securities being offering?

11. Does your jurisdiction require a hedge fund’s securities to be “registered” if they are to be offered to general public?

12. Does your jurisdiction permit/require hedge fund securities offered to retail investors to be listed and traded on a securities exchange?

13. Are hedge fund advisers and/or the hedge funds themselves permitted to advertise in newspapers, magazines and other periodicals? Are advisers/funds permitted to establish websites which permit unlimited access by retail investors/general public to access information posted on the site, including offering memorandums, performance history, etc. Does the answer depend upon whether the adviser/fund is “registered” or “authorized?”

Sales Qualifications/Sales Restrictions

14. If your jurisdiction permits hedge fund securities to be offered and sold to retail investors, are there special or unique licensing requirements which registered representatives of brokers/dealers are required to meet?

15. Are there other limitations or restrictions the sale of hedge fund securities to retail investors/general public which broker/dealers are required to follow? For instance, does your jurisdiction impose investor “net worth” requirements, minimum investment amounts requirements, only permit investment in FOHFs, liquidity or redemption obligations?

Retail Hedge Fund Disclosure Documents

16. Does your jurisdiction require hedge funds to provide retail investors with an offering memorandum with certain minimum disclosures? If yes, please identify the “minimum disclosures” which are required and discuss how those disclosures differ from typical CIS offering memorandum.

17. Does your jurisdiction require hedge funds to disclose investment limits on certain instruments, the amount of leverage to be used, concentration of investment in certain companies or sectors, disclose short selling or other types of strategies? Please describe.

18. Does your jurisdiction require certain specific warnings for hedge funds which are offered and sold to retail investors? If yes, please describe.

Retail Hedge Fund Reporting Requirements

19. Does your jurisdiction require hedge funds which are offered and sold to retail investors to provide periodic reports – monthly/quarterly – regarding investment performance.

20. Does your jurisdiction require hedge funds which are offered and sold to retail investors to provide annual financial statements. If so, are such annual financial statements required to prepared in accordance with US GAAP or International Accounting Standards?

21. Does your jurisdiction require hedge funds which are offered and sold to retail investors to file with the regulator the annual financial statements they provide to investors?

22. Please discuss the level of disclosure required in such reports regarding underlying investments? Is such disclosure consistent with retail CIS reporting requirements or is it more detailed? Is the reporting more or less frequent?

23. Has your jurisdiction encountered valuation problems with hedge funds or CIS? Do you have a clear policy regarding valuation of assets by CIS/hedge fund managers? Do you require independent 3rd party valuation of CIS/hedge fund assets? Does the policy only apply to certain types of assets – derivatives, unlisted

securities, and other illiquid instruments – or all assets? Is the same policy applied to commercial and investment banks?

24. Does your jurisdiction regulate prime brokerage arrangements? What are the main regulatory requirements which are imposed in the contractual arrangements related to prime brokerage? For purposes of this question, the term “prime broker” means an agent/person providing securities services to hedge funds, including securities execution, lending and borrowing services which hedge funds may use to leverage their positions as well as short stocks.

Examination and Enforcement

25. Does your jurisdiction examine hedge funds or their advisers? If so, please identify the examination cycle (once every 5 years, risk based, etc). In addition, please briefly discuss how the examination may differ from the examination of a CIS.

26. Please identify the average number of customer complaints your jurisdiction receives annually regarding hedge funds. How does this compare with the average number of customer complaints your jurisdiction receives annually regarding CIS.

27. How many administrative or regulatory actions has your jurisdiction taken against hedge funds in the last 5 years? Please provide some idea as the types of infractions and the types and size of penalties.

28. Please estimate the average annual number of civil lawsuits against hedge funds in your jurisdiction.

29. Please discuss any other problems/issues which your jurisdiction has encountered with hedge funds.

Appendix C

Summary of the Responses Provided by SC5 Members

General Background Information :

1. **Please provide an estimate regarding the number of hedge funds in your jurisdiction and estimate the amount of assets under management.**

Jurisdiction of SC5 Members	Number of registered hedge funds	Assets under management for registered hedge funds (in U.S. Bln)	Number of offered but not registered hedge funds	Assets under management for offered but not registered hedge funds (in U.S. Bln)
Australia	at least 100	> 20 Bln FUM	160	< 20 Bln FUM
Brazil	337	17.486	N/A	N/A
Canada (Ontario and Quebec)	13	0.5	178	10
France	241	30	0	0
Germany	18	1.68506	N/A	N/A
Hong Kong	13	1.17	87	10.10
Ireland	N/A	N/A	N/A	N/A
Italy	123	14.235	N/A	N/A
Japan	23[20]	1.2[19]	208[20]	5.9[21]
Jersey	98	£12,218	N/A	N/A
Luxembourg	42	4.2 EUR	N/A	N/A
Mexico	N/A	N/A	N/A	N/A
Netherlands	40	2.5	N/A	N/A
Portugal	2	0.04	N/A	N/A
Spain[21]	N/A	N/A	N/A	N/A
Switzerland	206	not known	N/A	N/A
United Kingdom	0	0	N/A	N/A
USA (CFTC)	57	7.6	3,500	606.4
USA (SEC)	0[22]	0	7000	870

[19] This is the number and the amount of publicly offered hedge funds (including funds of hedge funds and investment trusts the hedge fund strategies) established in 2004.

[20] This is the number and the amount of privately placed hedge funds (including funds of hedge funds and investment trusts with hedge fund type strategies) established in 2004.

[21] Because the regulatory development of hedge funds in Spain has not yet come to an end, the answers by Spain summarized herein must be taken as provisional and may be subject to change.

[22] In general, for purposes of this questionnaire, the staff of the USA-SEC generally view "hedge fund" as referring to CIS that are not registered and therefore would not include registered CIS that engage in hedge fund-like strategies or registered funds of hedge funds.

2. Please identify the hedge fund strategies which are being used/offered in your jurisdiction.

Hedge Fund Strategy	Australia	Brazil	Canada-Ontario	Canada-Quebec	France	Germany	Hong Kong	Ireland	Italy	Japan	Jersey	Luxembourg	Mexico	Netherlands	Portugal	Spain	Switzerland	United Kingdom	US (CFTC)	US (SEC)
Convertible Arbitrage	Y	Y	Y	Y	Y		Y	Y	Y	Y	Y	Y		Y			Y	Y	Y	Y
Event Driven	Y	Y	Y	Y	Y			Y		Y	Y	Y		Y			Y	Y	Y	Y
Fixed Income Arb.	Y	Y	Y	Y	Y			Y	Y	Y	Y	Y		Y			Y	Y	Y	Y
Long/Short Equity	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y		Y			Y	Y	Y	Y
Emerging Markets	Y	Y	Y	Y	Y			Y		Y	Y	Y					Y	Y	Y	Y
Global Macro	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y		Y			Y	Y	Y	Y
Managed Futures	Y	Y	Y	Y	Y	Y		Y	Y		Y	Y		Y			Y	Y	Y	Y
Dedicated Short Bias			Y	Y	N			Y			Y	Y					Y	Y	Y	Y
Fund of Funds	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y		Y	Y		Y	Y	Y	Y
Alternative Approaches	Y	Y	Y	Y	Y	Y	Y	Y			Y	Y					Y	Y	Y	Y

Definitions

	Australia	Brazil	Canada-Ontario	Canada-Quebec	France	Germany	Hong Kong	Ireland	Italy	Japan	Jersey	Luxembourg	Mexico	Netherlands	Portugal	Spain	Switzerland	United Kingdom	US (CFTC)	US (SEC)
3) Is the term "hedge fund" defined?	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N
4) Does your definition of "hedge fund" differ from your definition of "collective investment scheme"?	N	N	N	N	N	N	N	NA	NA	N	NA	NA	N	N	N	N	NA	N	N	Y
5) Does your jurisdiction distinguish between "hedge funds," "private equity funds," "venture capital funds," and "futures funds"?	N	Y	Y	Y	Y	Y	Y	N	Y	N	Y	Y	N	N	Y	Y	N	N	Y	Y
6) Does your jurisdiction distinguish between hedge funds which are single strategy funds versus fund of hedge fund operations?	N	N	N	N	Y	Y	Y	N	Y	N	Y	Y	NA	N	Y	Y	N	N	Y	N

Adviser Regulation/Fund Regulation/Securities Regulation

	Australia	Brazil	Canada-(Ontario)	Canada-(Quebec)	France	Germany	Hong Kong	Ireland	Italy	Japan	Jersey	Luxembourg	Mexico	Netherlands	Portugal	Spain	Switzerland	United Kingdom	US (CFTC)	US (SEC)
7) Is the Adviser to a hedge fund regulated?	Y	Y	Y	Y	Y	N	Y	Y	Y	Y[23]	Y	Y	NA	Y	Y	Y	Y	Y	Y	Y
8) Do regulations differ for advisers of privately placed vs. public fund?	Y	N	N	N	N	N	Y	N	NA	N	Y	N	NA	NA	Y	NA	Y	N	Y	N
9) a) Is the hedge fund itself regulated?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	NA	Y	Y	Y	Y	N	N	N
b) Is the fund required to register?	Y	Y	N	N	Y/N[24]	Y	Y	Y	Y	Y	Y	Y	NA	Y	Y	Y	Y	N	N	N
10) Are hedge funds specifically restricted by leverage, short selling or derivatives?	Y	Y	N	N	Y/N[25]	Y	N	Y[26]	N	Y	Y	Y	NA	N	Y	Y	Y	NA	N	NA
11) Must hedge funds be "registered" if offered to the general public?	Y	Y	Y	Y	Y	Y	Y	Y	NA	Y	Y	N	Y	N	Y	Y	Y	N	Y	NA
12) Are hedge fund securities permitted to be listed on a securities exchange?	Y	Y	Y	Y	N[27]	Y	Y	N	N	Y	Y	Y	NA	Y	Y	N	N	Y	NA	NA
13) a) Are the hedge funds permitted to advertise?	Y	Y	Y	Y	Y	N	Y	Y	N	Y	Y	Y	NA	Y	Y	Y	Y	N	Y	N
b) does answer depend on whether fund is "registered"?	N	N	N	N	Y	N	Y	Y	N	N	N	N	NA	N	Y	Y	Y	N	N	N

[23] The current legislation in Japan does not provide for any explicit definition of hedge funds, therefore, the answers to the questions 7 to 26 are on hedge funds including funds of hedge funds and investment trusts with hedge fund type strategies. Especially the answers to the questions 9 to 26 are on publicly offered funds. In addition, arrangement and distribution of hedge funds are allowed if existing laws and regulations for funds and investment advisors (*e.g.*, disclosure, registration of investment advisors, etc.) are satisfied.

[24] In France, contractual funds are not registered and they are only filed with the regulator. Some other funds with lighter investment rules, using leverage effects (ARIEL) or no leverage effect (ARIA) are registered funds.

[25] In France, certain restrictions regarding leverage, short selling or the use of derivatives will apply where a fund is authorized as an Aria Fund. A contractual fund is not subject to such restrictions.

[26] In Ireland, certain restrictions regarding to leverage, short selling or the use of derivatives will apply where a fund is authorized as a Professional Investor Fund (PIF) as defined in Appendix D. A Qualifying Investor Fund (QIF) is not subject to such restrictions.

[27] French hedge funds are not listed in France but could be on foreign stock exchange markets.

Sales Qualifications/Sales Restrictions

	Australia	Brazil	Canada-Ontario	Canada-Quebec	France	Germany	Hong Kong	Ireland	Italy	Japan	Jersey	Luxembourg	Mexico	Netherlands	Portugal	Spain	Switzerland	United Kingdom	US (CFTC)	US (SEC)
14) If sales to retail investors are permitted, are there unique licensing requirements which registered brokers are required to meet?	N	Y	Y	Y	NA	N	N	NA	NA	N	NA	N	NA	N	Y	N	N	N	N	NA
15) Are there other limitations on the sale of hedge fund securities to retail investors which brokers are required to follow?	N	N	Y	Y	Y	N	Y	NA	NA	N	Y	N	NA	N	Y	Y	Y	N		Y

Retail Hedge Fund Disclosure Documents

	Australia	Brazil	Canada-Ontario	Canada-Quebec	France	Germany	Hong Kong	Ireland	Italy	Japan	Jersey	Luxembourg	Mexico	Netherlands	Portugal	Spain	Switzerland	United Kingdom	US (CFTC)	US (SEC)
16) Are hedge funds required to provide retail investors with an offering memorandum with certain minimum disclosures?	Y	Y	Y	Y	Y	Y	Y	NA	NA	Y	Y	Y	NA	Y	Y	Y	Y	Y	Y	NA
17) Are hedge funds required to disclose investment limits, amount of leverage, concentration of investment, short selling or other strategies?	N	Y	Y	Y	Y	Y	Y	NA	Y	Y	Y	Y	NA	Y	Y	N	Y	N	Y	NA
18) Are certain specific warnings for hedge funds offered to retail investors required?	N	Y	Y	Y	Y	Y	Y	NA	NA	Y	NA		NA	Y	Y	Y	Y	N	Y	NA

Retail Hedge Fund Reporting Requirements

	Australia	Brazil	Canada-Ontario	Canada-Quebec	France	Germany	Hong Kong	Ireland	Italy	Japan	Jersey	Luxembourg	Mexico	Netherlands	Portugal	Spain	Switzerland	United Kingdom	US (CFTC)	US (SEC)
19) Are hedge funds which are offered and sold to retail investors required to provide periodic reports regarding investment performance? If yes, how many times per year is a report required?	2	12	2	2	2 to 4	N	4	NA	NA	1	NA	2 to 12	12	2	N	NA	2	N	4 to 12	NA
20) a) Are hedge funds which are offered to retail investors required to provide annual financial statements?	Y	Y	Y	Y	Y	Y	Y	NA	NA	Y	NA	Y	Y	Y	Y	NA	Y	N	Y	NA
b) Are the financial statements required to be in accordance with US GAAP or International Accounting Standards?	Y	N	N	N	Y	N	N	NA	NA	NA	NA	N	N	Y	Y	NA	Y		Y	NA
21) Are the financial statements required to be filed with the regulators?	Y	Y	Y	Y	Y	Y	Y	NA	NA	Y	NA	Y	Y	Y	Y	NA	Y	N	Y	NA
22) a) Is the disclosure of such reports consistent with CIS reporting requirements?	Y	Y	Y	Y	Y	N	Y	NA	Y	Y	NA	Y	Y	Y	Y	NA	N	NA	Y	NA
b) Is the reporting more frequent than for CIS?	N		N	N	N	N	Y	NA	Y	N	NA					NA	N	NA	Y	NA
23) a) Has your jurisdiction encountered valuation problems with hedge funds or CIS?	Y	N	N	N	Y		N	N	N	N	N	N	NA	Y		NA	N	Y	Y	Y
b) Do you have a specific policy regarding valuation of assets by managers?	N	N	N	N	Y	Y	Y	Y	Y	Y	N		NA	Y	Y	NA	Y	N	Y	Y[28]
24) Does your jurisdiction regulate prime broker arrangements?	Y	NA	N	N	Y	Y	Y	Y	Y	N	Y	N	NA	N	N	NA	N	Y	Y	Y

[28] The USA federal securities laws provide guidance concerning the valuation of CIS assets.

Examination and Enforcement

	Australia	Brazil	Canada-Ontario	Canada-Quebec	France	Germany	Hong Kong	Ireland	Italy	Japan	Jersey	Luxembourg	Mexico	Netherlands	Portugal	Spain	Switzerland	United Kingdom	US (CFTC)	US (SEC)
25) Does your jurisdiction examine hedge funds or their advisers? How frequently (in years between each examination)?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	3	≥1	2 or 3	NA	Y	Y	2 or 3	Y
26) a) Identify the average number of customer complaints received annually regarding hedge funds.	<3	NA	194	NA	0	NA		NA	<10	NA	0	0	NA	0	NA	NA	<10		10	NA
b) How does this compare to complaints received regarding CIS?	583	<	78	NA	<	NA		NA	<	NA	100	NA	NA		NA	NA	=		NA	NA
27) How many administrative or regulative actions has your jurisdiction taken against hedge funds in the last 5 years?	2		3	2	0	0	0	0	0	NA	0	1	NA	0	0	NA	10	0	43	51
28) Average annual number of civil lawsuits against hedge funds.		NA	0	0	0	0	0	NA	0	NA	0	NA	NA	0	NA	NA	few	0	9	NA
29) Other problems /issues.	N	Y	Y	Y	Y	Y	N	Y	Y	N	Y	NA	NA	N	N	NA	Y	N	Y	Y

Appendix D

Definition of Hedge Fund or Characteristics Used to Identify Hedge Funds Among SC5 Members

	Definition or Description of Hedge Fund
Australia	There is no legal definition of hedge fund; no specific restrictions on which CIS can be called hedge funds. Hedge funds are regulated like all other managed CIS. In Australia, there are few restrictions on what a managed CIS can invest in so any managed investment scheme could invest in alternative investments and otherwise behave "like a hedge fund" without calling itself a hedge fund. The Australian hedge fund industry is dominated by FOHFs, investing in single strategy offshore funds. Under Australian law, a registered CIS can generally only invest in other registered CIS. If a CIS is marketed to retail investors, the CIS must be registered. There is a prohibition of certain retail CIS offerings such as CIS using certain types of leverage, derivatives and short-selling.
Brazil	No definition of hedge fund. CIS using "hedge fund" strategies referred to as multi-market category of funds (e.g., CIS with investment policies that involve certain risks). Most are multi-strategy funds but seeing single strategy. There are current CIS that use hedge fund strategies on condition that these CIS adopt specific "divulgation" requirements for strategies or if intended for qualified investors. Some CIS are limited to qualified investors, which is designed to protect retail investors against riskier and more sophisticated investments.
France	No definition of hedge fund. CIS managers can manage domestic funds using alternative investment strategies subject to a regulatory framework designed for the investment strategy (e.g., there are less stringent investment rules for certain funds). New regulations were promulgated in late 2004. The following funds can be considered onshore hedge funds: (1) Registered funds of alternative funds (Funds of Hedge Funds) (2) Registered funds with lighter investment rules ("ARIA") (3) Registered funds with lighter investment rules and with leverage effect ("ARIEL") (4) Contractual funds – management of these funds is freely determined between fund owners and management company ; (5) FCIMT (fonds communs d'intervention sur les marchés à terme). Each of the funds in categories (1), (2) and (3) above are subject to different investment rules (e.g., diversification, leverage) and, in addition, investment thresholds and/or net worth requirements are imposed on investors, meaning such funds are marketed and sold to different categories of retail investors. Contractual funds are not subject to any rules relating to diversification or leverage, however there are investor requirements relating to net worth and minimum investment thresholds. Except for contractual funds, all types of onshore hedge funds are authorized by AMF. For contractual funds, the AMF is only informed through a filing. No public distribution of offshore funds allowed except via a registered fund of alternative funds. FOHF is defined as a fund with an exposure higher than 10% to non-regulated foreign hedge funds, future funds, venture capital funds (among others).

	Definition or Description of Hedge Fund
Germany	No definition of hedge fund, although view as referring to a particular type of CIS. Legislator has introduced new class of CIS, funds with additional risks, which are allowed to perform the investment strategies particular to hedge funds (e.g., short sales, leverage). German law also permits funds of funds with additional risks, however leverage and short sales may not be effected for funds of funds with additional risks. German law does not recognize a class funds that are offered only to specified investor groups. Single hedge funds are free from many investment restrictions. German hedge funds cannot invest in companies if the value cannot be determined and for unlisted companies, cannot invest above 30% of the value of the fund. German hedge funds cannot invest in real estate, real property companies or commodities (other than precious metals). For funds of hedge funds, the fund only can invest in single hedge funds and among other things, there is a limit of up to 20% of the value of the fund in an individual target fund. Public marketing of hedge funds is prohibited (but FOHFs can be publicly marketed).
Hong Kong	No definition, a type of CIS. Hedge funds are viewed as non-traditional CIS with different characteristics and strategies compared to traditional funds. There are guidelines for some specialized funds such as futures funds and hedge funds. A specialized fund is any fund whose primary objective is not investment in equities and/or bonds or any fund not meeting the requirements for traditional funds. Hong Kong has a code that sets forth the authorization and disclosure requirements for hedge funds and FOHFs offered to the retail public. Authorized retail FOHFs are required to invest in at least five underlying funds and not more than 30% of its total NAV may be invested in any one fund. Different types of authorized retail hedge funds (e.g., single hedge funds, FOHF, hedge funds with a capital guarantee feature) are subject to different minimum subscription thresholds. Hong Kong requires “monthly dealing” for authorized hedge funds, too. There also are hedge funds that are offered only to “professional investors” that are not authorized by the Hong Kong regulator.
Ireland	No CIS is authorized as a hedge fund. There are professional investor funds (“PIFs”) and qualifying investor funds (“QIFs”) that employ generally observed characteristics of hedge funds (e.g., short sales, significant borrowing, derivatives). PIFs have some limits on leverage but there are no limits for QIFs. PIFs impose minimum subscription requirements and QIFs have minimum subscription requirements and qualifying criteria for net worth. There are FOHFs for retail and professional investors. A FOHF is defined as a CIS that invests in unregulated CIS, including hedge funds and alternative investment funds. For retail FOHFs, if the underlying CIS are unregulated, the CIS can have no more than 20% in any one fund and the underlying funds are subject to an independent audit and need independent custody arrangements.
Italy	No definition. In Italy, hedge funds are allowed to: (1) invest in a range of financial instruments and commodities broader than the investments of ordinary mutual funds (i.e., listed and unlisted financial instruments, bank deposits, real estate, receivables and instruments with a market price) and (2) carry out investment strategies not bounded by prudential rules of the Bank of Italy for ordinary CIS. If a fund invests more than 10% of its NAV in unlisted securities, such funds must have the form of closed-end funds (e.g., private equity and venture capital funds). Participation in a hedge fund is regulated by fund rules and cannot be offered to retail investors but only to particular categories of investors which are assumed to be informed of the risks of such funds. There cannot be more than 200 investors per hedge fund and there is a minimum subscription requirement.
Japan	No specific definition is provided by laws and regulations. However, many hedge funds have features of CIS, and are regulated as CIS under Japanese legal framework. At the industry level, funds which have some specific elements, including (i) adopting alternative strategies, (ii) using leverage, (iii) having high exposure to risks, and (iv) charging a performance fee, are identified as so-called “hedge funds”. Such hedge funds include funds of hedge funds, and investment trusts with hedge fund –like strategies. In addition, fund of funds (including a fund of hedge funds) is defined by a Japanese SRO as an investment trust which proposes to invest in a securities investment trust, real estate investment trust, securities investment companies or real estate investment companies.

	Definition or Description of Hedge Fund
Jersey	No definition. Hedge funds, private equity funds and futures funds are often identified by the investment policy and restriction of the fund. Jersey does not permit hedge funds established in Jersey to be marketed to the general public. Such funds can be established in Jersey when offered to expert investors in accordance with Jersey's laws (which includes a definition of an expert investor and prescribes the structure and operation of the fund, including the content of the offering document). A fund of hedge funds can be offered to the general public subject to certain restrictions such as the fund must invest in at least 5 hedge funds with no more than 30% in any one hedge fund. To be eligible to promote or operate a fund of hedge funds in Jersey, the promoter must demonstrate high stature (e.g., financial resources, reputation) and a track record in operating such funds.
Luxem-bourg	Hedge funds are not specifically defined. In Luxembourg, hedge funds often are identified as funds adopting "alternative" investment strategies pursuant to Luxembourg circular 2002/80 (i.e., funds using investment strategies similar to those used by hedge funds or alternative investment funds). Luxembourg circular 2002/80 applies to hedge funds and funds of hedge funds. This circular requires sufficient risk spreading and therefore imposes specific investment restrictions including, among others, restrictions on short-selling, borrowing, investments in other investment funds and securities lending. All Luxembourg domiciled investment funds require prior regulatory approval before commencing operations. Hedge funds are subject to CIS rules as well as the rules for funds engaging in alternative investment strategies. Hedge funds are a type of CIS according to their investment policy.
Mexico	No hedge fund covered by Mexican law. There are proposals to allow debt and equity funds to invest in derivatives and hedge funds. The proposals define a hedge fund as securities issued by investment companies or private funds that use sophisticated hedging techniques, arbitrage or highly leveraged with speculative purposes.
Nether-lands	No definition; treat like any other CIS. All CIS offered to the public must apply for a license. There are no investment limits with respect to leverage, short selling or derivatives.
Ontario	Conventional CIS are subject to restrictions prohibiting leverage and short selling, investing in illiquid securities so cannot operate like "hedge fund." There are private "hedge funds" for institutional investors that are not available to the public or retail investor. There are however some "public" hedge funds organized as (1) commodity pools or (2) closed-end funds. Of the 6 closed-end hedge funds, three are fund of funds strategy and the other three invest directly in a long/short strategy. Public or retail CIS (including public closed-end funds) file a prospectus. If a fund is offered to exempt purchasers, no prospectus is required and there are no investment restrictions.
Portugal	No definition. Hedge funds must be authorized by CMVM. Hedge funds are included in the "special investment funds" category, which was recently added to legal framework and covers a wide range of strategies, instruments and techniques. Portugal has two main groups of CIS (1) special investment funds (e.g., wide range of strategies, almost no portfolio composition thresholds); and (2) private equity funds that can be (a) designed for qualified investors or (b) retail investors. The private equity funds are bankruptcy remote vehicles investing in high growth and profit potential companies. CMVM has wide discretionary power to analyze a fund and decide whether or not it will be authorized. Distinction of whether a fund is a single strategy hedge fund or a FOHF is important to CMVM's evaluation of the fund and any requirements for authorization such as minimum subscription amounts and disclosure. Leverage, short sales and derivatives may not represent more than 50% of the fund's NAV. There also is a minimum subscription amount in the law for special funds that invest in securities and special funds that invest in other assets such as commodities. CMVM can impose higher or lower amounts.
Quebec	No definition. No retail investment in a fund using high level of derivatives and non-standard investment strategies. FOHFs for retail investors also not allowed. "Hedge fund" generally not "mutual fund." There is a class of funds sold only to accredited investors.

	Definition or Description of Hedge Fund
Spain	A new CIS law was enacted in February 2004 introducing new investment possibilities, broader investments instruments and risk limits depending on the CIS, type of investor and type of assets. The Royal Decree for CIS that allow HF (Unrestricted CIS and CIS of Unrestricted CIS) has been approved by the Spanish Government and came into force on November 9, 2005. "Unrestricted CIS" will be for qualified investors with more flexibility for diversification, indebtedness, liquidity, derivatives and leverage among others. Unrestricted CIS will have minimum initial investments, marketing limited to institutional investors, minimum of 25 investors, in-kind purchases and redemptions allowed, quarterly NAV, no ceilings on fees/commissions, maximum indebtedness limited to 5 times, among others. Retail investors will be able to invest in the CIS of unrestricted CIS. At least 60% of assets must be invested in unrestricted CIS (no more than 10% in any one fund), no ceiling on fees/commissions, among other conditions. Nevertheless, there are CIS carrying out different alternative investment strategies such as market neutral, event-driven, CTA, long-short, *etc*., while complying with general regulations for diversification and leverage limits.
Sweden	
Switzer-land	Only authorized funds may be sold to the public. Foreign, unregistered funds can be distributed to institutional investors. Majority of hedge funds are funds of hedge funds (97%). No defined term "hedge fund" and cannot use in CIS name. There is a category of funds – "other funds bearing special risks."
UK	No definition of hedge fund. UK regime makes marketing unregulated CIS difficult unless to sophisticated investors. Hedge fund refers to a strategy rather than a structure. FOHFs are not authorized for retail investment but can be for institutional investment.
USA (SEC)	No definition of hedge fund. The term "hedge fund" generally is used to refer to an entity that holds a pool of securities, and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company. One of the first hedge funds invested in equities and used leverage and short selling to "hedge" the portfolio's exposure to movements of the corporate equity markets. Over time, hedge funds have diversified their portfolios to include other financial instruments and engage in a wider variety of investment strategies. In addition to trading in equities, hedge funds may trade fixed income securities, convertible securities, currencies, exchange-traded futures, over-the-counter derivatives, futures contracts, commodity options and other non-securities investments. Hedge funds may or may not utilize hedging and arbitrage strategies and may engage in relatively traditional, long-only equity strategies.
USA (CFTC)	There is no formal definition of a hedge fund but informally understood to be a privately offered investment fund or pool that trades and invests in various assets such as securities, commodities, currency and derivatives. In the United States, hedge funds typically compensate the manager in part on profits of the pool. Hedge funds are commonly offered to institutions, pension funds, endowments and very wealthy individuals.