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Dear Andrew, Rebecca and Ashley,

Please find attached ISDA's comments covering both DP05/3 (on 'Wider Range' Retail Investment Products) and DP05/4 (Hedge Funds).

We have submitted a composite response, as we agree with FSA's premise that the two papers should be taken in conjunction, with a number of overlapping issues. This is particularly true of the need not to overlay unnecessary extra regulation on top of existing measures.

ISDA would, naturally, be delighted to discuss any of the matters covered in our response in more detail.

Yours sincerely,



Richard Metcalfe
Senior Policy Director

1. Introduction

In the response below, ISDA¹ comments on both DP05/4 (on hedge funds) and DP05/3 (on retail investment products), between which FSA has understandably established a conceptual link. In responding, we have adopted a thematic approach, as we do not wish to comment on each individual question in the two papers. We have focused instead on what we consider to be the issues of principle.

We believe both papers to be helpful and timely, in the sense that they afford an opportunity to determine the extent and nature of any policy issues in either area.

As regards **DP05/4 (on hedge funds)**, we support the approach, whereby the focus of supervision remains on those entities which are core intermediaries and authorised persons or else have direct contact with retail investors, rather than on legal entities which are simply active participants in wholesale financial markets. Continued monitoring of such intermediaries and advisors appears to us to offer the best means of assessing the impact on markets (and on individual authorised institutions) of hedge fund activity. The regulator does, after all, already have a responsibility with regards to those authorised institutions, and may in practical terms find it more efficient to use the information that already exists within or about those firms. Focusing on these entities that are already regulated also offers an adequate window on retail activity in relation to hedge funds.

Having said that, establishing a degree of specialisation within the regulator on hedge fund-related business could clearly help in structuring this monitoring to greatest effect. This does not, however, mean that regulation needs to be developed specifically in relation to hedge funds.

Similarly, as regards **retail products (DP05/3)**, we consider that it is unnecessary and impractical to target 'wider-range' products with specific regulation. We prefer to see a measured application of the protections already afforded to retail consumers.

We also comment below specifically on the issue of disclosures of derivatives and CFDs, touched on in paragraph 4.12 of DP05/4. We have concerns about any extension of disclosure requirements, when in our view even the recent change of policy in relation to bid situations entails significant flaws.

¹ ISDA is the trade association representing participants in the privately negotiated (or over-the-counter, 'OTC') derivatives industry. Its membership comprises more than 600 firms, including the world's largest commercial, investment and universal banks (and thereby prime brokers); corporations; government entities; and other interested parties. This includes a number of hedge funds. ISDA was chartered in 1985 and today represents institutions from 47 countries around the world. OTC derivatives include swaps, options, and forwards on interest rates, currencies, commodities, equity and credit.

2. Hedge funds: use of derivatives; characterisation; regulation

ISDA's membership includes a wide range of parties for whom the continued development of healthy over-the-counter derivatives markets is an important business consideration. At the same time, public policy generally recognises the value to the broader economy of such markets in financial risk transfer.

Hedge funds are an important category of participant in OTC derivatives, as reflected in the fact that a number of such funds are also members of ISDA (alongside entities such as corporate treasury arms, national debt management agencies and 'traditional' fund managers). Hedge funds can bring transactional liquidity to the market and may, through their trading, express views which in effect constitute new 'information' for the market, contributing to its function of establishing a price for certain risks.

Like other categories of participant, however, hedge funds clearly play a different role from the dealer firms who constitute the core of the market. ISDA shares the view that it is appropriate to apply direct regulation only to those types of firms that are truly essential to the functioning of the financial markets. To extend regulation beyond such entities may, at the extreme, introduce an element of moral hazard. Our main concern, however, would simply be that the move would be an unnecessary broadening of regulation, which would accordingly amount to an increased cost to industry, for no clear benefit.

We would add that the confidential and sometimes fast-moving nature of hedge funds' positions means that a primary focus of regulation should be on the procedures that their counterparties have in place to manage associated risks, whether market, credit or operational. It may simply be impractical to track the exposure of a given dealer to a given hedge fund or funds in real time, though clearly there may scope to do so on a less frequent basis.

DP05/4 correctly identifies use of derivatives as one of a number of potential characteristics of hedge fund management technique. We note that this use of derivatives reflects the efficiency of risk-transfer brought by derivatives. But, to address one of the questions that the paper explicitly raises (Q4), we do not believe use of derivatives is a sound, let alone optimal, basis for a definition of hedge funds; or even a partial definition.

Derivatives come in a wide variety of forms, some of them highly tailored. In other words, they can satisfy a number of distinct investment objectives and can constitute any of a number of strategies or positions. So, while it may be feasible technically to establish a criterion of 'use of derivatives', this will tell one very little about the nature of the entity using them. Nor does it allow one to infer a dependence between hedge funds on the one hand and, on the other, liquidity in any given sector of the derivatives market.

At the same time, there is a slow but steady growth in the use of derivatives by what are typically referred to as 'traditional' funds. This is reflected in the companion DP (05/3), and more fundamentally in the changes brought about by UCITS III. In other words, use of derivatives is not even diagnostic of any particular sort of investment entity.

An important but sometimes forgotten feature of derivatives is that they are an alternative way of taking a position that could be replicated directly in the market to which they relate. They are so popular precisely because they offer a more efficient means of establishing an economic position that would, in any case, be of interest to the user in a given asset class, whatever the instrument by which they construct that position. In that sense, derivatives do not constitute an asset class per se. To categorise investors on the basis of their use of derivatives does, therefore, suffer from a conceptual weakness.

We recognise that the definition of ‘hedge funds’ remains elusive. We would, however, argue that this is not a problem unless hedge funds are subject to regulation, which we do not believe to be appropriate. It is true that the range of investment ‘styles’ employed by hedge funds and the potentially market-sensitive nature of their tactics or positions at any given point in time introduce particular challenges. Clearly, it is important for any regulated entity to understand enough about a given hedge fund’s approach to be able to manage the counterparty risk associated with it. We do not, however, see that any generic definition of hedge funds will help in this regard. Nor do we see such an all-encompassing definition (or, even more problematically, a taxonomy) as particularly helpful to investors.

3. Retail products and derivatives DP05/3

A further point on the use of derivatives by funds generally is as follows. At various points in DP05/3, it is suggested that UCITS III allows unfettered use of derivatives as investments (as distinct from using them as hedges or as a means of efficient portfolio management). This, however, is not the case. For, while UCITS III does allow some use of derivatives for investment purposes, this is subject to potentially very constraining limits.

(It is made especially so by the imprecise language of the Directive. In particular, the wording covering the amount of risk that may be taken on via derivatives makes it problematic to use options, whose ‘delta’ [or price variability] may itself vary as a function the price of the underlying.)

We consider this point to be germane to the discussion, since it may give rise to a misleading impression as to the accessibility to retail investors of ‘naked’ positions in OTC derivatives.

4. Hedge funds and operational risks; credit risk mitigation (DP05/4)

ISDA believes that many lessons have been learnt since the events of August-September 1998 raised questions about the management of risks associated with trading with hedge funds.

Clearly, the timely signature of master agreements, give-up arrangements and credit support documentation remains an important basis for a trading relationship. Equally, regulators can play an important role by lending weight to the growing industry efforts to optimise post-trade efficiency, including the documentation of not just new trade details but also transfers (including ‘novations’). ISDA welcomes the prominence regulators have given to such issues in recent

months and firmly believes that extending initiatives and solutions to a wide a range of significant market participants is highly desirable.

The events of 1998 highlighted the importance to authorised institutions of making full and systematic use of collateral arrangements. Industry research² shows that market participants continue to put new collateral arrangements in place, with both the number of arrangements and the amount of collateral posted growing substantially. More anecdotal evidence consistently suggests that (where relevant) initial margin provisions are more readily enforced. (Please note, however, that the level of margin required will not necessarily be as high as in the past, due to advances in counterparty risk modelling, particularly across portfolios.)

Also in relation to collateral, we wish to take issue with the inference in paragraph 3.48 of DP05/4 that ‘rehypothecation’ by their prime broker of assets posted as collateral by a hedge fund is somehow inimical to the hedge fund’s interests. Generally speaking rehypothecation – or, strictly speaking, re-use – is a standard feature of collateral arrangements and allows dealer firms to maximise the cost-effectiveness of their collateral process. Any undue constraint on this efficiency could only have a negative effect on the price at which services were offered to customers of the firms.

Naturally, the terms of the collateral arrangement should be such that the party providing the collateral has appropriate rights relating to the return of any assets that they have posted (or, in the event of the counterparty’s default, offset of exposures to that counterparty against collateral posted with it). These rights, however, are typically included as standard in industry agreements. Thus, there will be a requirement to return the same or equivalent assets, upon satisfaction of any liability or the elimination of relevant exposures.

Only when excess collateral is held (against which there is therefore no possibility, in the event of the counterparty’s default, of offsetting actual current exposures) could an issue arise in relation to re-use. We believe that this, however, is a matter for the parties to the relationship, since it goes to issues of commercial sensitivity, relating to matters such as the volatility of positions and the relative creditworthiness of the counterparties. We certainly see no general policy problem, however, in ‘rehypothecation’ – quite the contrary, in fact.

On a related topic, we note that the issue of cross-product netting can be particularly relevant to exposures between hedge funds and dealer firms, particularly their prime brokers. The financing of hedge-fund positions by means of securities lending/repos, taken together with any use hedge funds do make of derivatives, makes netting across these product ‘sets’ highly desirable. We see this as a good reason to ensure maximum accommodation – and indeed encouragement – of cross-product netting, as provided for in the Trading Book element of the new Basel/EU capital rules.

5. Retail products (DP05/3)

A number of points strike us as significant in relation to the subject matter of this DP:

² Viz, ISDA Margin Surveys, available at www.isda.org.

- We agree with the DP that it is hard – if not impossible – to define wider-range products (Qs 1 and 2).
- Various general protections rightly exist for the retail investor, at national and EU level.
- It seems to us that it is quite clear that investors must be expected to bear financial performance risk.
- Particular forms of vehicle (notably UCITS) are subject to specific regulation, precisely because they are intended for retail investors (and must accordingly conform to certain standards).
- Any risk of ‘mis-buying’ is one which falls at least in part on the investor.

In this environment, we question what would be achieved by regulating ‘wider-range products’ specifically. It would most likely be redundant and potentially confusing too. Moreover, such requirements would very obviously be vulnerable to obsolescence. (In this regard, we note that the very foundation of the DP on retail products is a notion of continuing product evolution.)

As regards wholesale market participants (to whom those selling retail products may turn for support in financial engineering), these may perform any of a number of roles in relation to a particular product, ranging from close collaboration with the distributor to a purely arm’s-length relationship with them as a counterparty on a hedge. Clearly, the extent of any responsibilities they may have towards any retail customers will be a function of the role they play. Equally clearly, however, the primary relationship is between the investor and the entity from which it buys the investment. If that intermediary does not deliver the products the investor requires (or that are suitable for the investor), they must bear appropriate responsibility.

We would draw FSA’s attention to the fact that private sector initiatives have already begun to think through many of the practical challenges facing wholesale providers of structuring, particularly as regards addressing the potential for reputational risk. For instance, in July 2005 the ‘Counterparty Risk Management Policy Group II’ published a document³ which, among other things, addressed this topic. In section VI (A.1, on p140) of this document, the CRMPG-II sets out a series of ‘Guiding Principles’, noting: “Financial intermediaries should re-evaluate their internal new-product controls to ensure that they adequately manage the heightened reputational and related risks associated with the issuance of complex structured securities sold to retail investors.” The paper also observes that “while appropriate disclosure and related sales practices [...] are important, they should not be seen as absolving even retail investors from their responsibility to ensure that they understand and carefully consider their investment alternatives”.

(With regards to DP05/4, the packaging or ‘wrapping’ of hedge fund investments for retail investors raises exactly the same issues. The key test to be satisfied is whether there is an appropriate amount of assessment of the suitability of that investment for that investor, and related risk disclosure, by the party dealing with that investor. While this may logically require the clarification of some terms and techniques that are specific to a hedge fund or funds [including any significant use they may make of derivatives], it is also logically true that this will

³ *Toward Greater Financial Stability: A Private Sector Perspective* – see <http://www.crmgroup.org/>

be an extension of the exercise that would apply to the marriage of any investor and investment. The principle of ‘caveat emptor’ will play at least some role in this, and possibly a predominant one.)

While DP05/3 mainly focuses on impacts on investors, we note that the possible opportunity cost associated with any unnecessary limiting of choice as to funds would be a cost for intermediaries too, in terms of lost opportunities for business.

We would note also that retail investors appear to be highly responsive to taxation effects. These, of course, remain very much a matter for national discretion. It therefore seems obvious that, while the nature of the regulatory treatment of investment products will clearly be significant, the interplay between this and taxation effects will be a critical factor in the relative standing and development of markets in various jurisdictions. This makes it impossible for any regulatory treatment to work in a vacuum. A priori, this will tend to make a light touch more appealing, as it will simplify analysis for providers and consumers of financial products.

Finally on DP05/3, the paper appears to imply that there has been a rather sudden and unexpected emergence of new types of investment product. While the distribution and development of such products is indeed growing, we note that this is a trend that has been building for many years and that the notion of structured investments is far from new. This, in our view, weakens any argument for product-specific rules.

By way of background, we note that a subset of over-the-counter derivatives have reached a point where it is possible to transact on relatively standardised terms, with some intermediaries willing to offer ‘execution-only’ services. The instruments that would fall into this category includes not only items such as equity options/warrants but also interest rate and currency swaps. We highlight this to stress that the mere inclusion of a derivative position in a portfolio should not in itself be taken to indicate complexity⁴.

6. Disclosures of derivatives positions (paragraph 4.12)

In paragraph 4.12, FSA refers to the recent policy debate on disclosures relating to CFDs and to analogous positions in other derivatives. FSA notes that it welcomes the Takeover Panel’s proposals to extend disclosure requirements to such instruments. Such a move is presumed to “bring more market transparency”.

As ISDA has stated in its responses to the Takeover Panel consultations on this subject, this is itself a questionable conclusion, with many factors to take into consideration. A crucial one is the fact that cash-settled derivatives provide a fundamentally different set of rights from physically settled instruments, which establish a clear ownership link with the securities in question, whereas cash-settled derivatives very clearly do not.

⁴ ISDA, jointly with other trade associations, has made exactly this point in connection with implementing measures for the Markets in Financial Instruments Directive.

The Takeover Panel has chosen to proceed with its plans, but at least has done so on what it believes to be a balanced judgement, relating to a specific and occasional set of circumstances. It believes that the benefits of its new rule outweigh the disadvantages in the peculiar and sensitive circumstances of a bid, where at least only a limited number of positions will fall under the requirements. In the discussion in para 4.12, however, FSA makes no reference to this background to the issue, and appears to assume that there is a proven policy benefit in extending disclosure requirements to any cash or derivative position. We believe this would be quite unwarranted.

We will save any further comment for any consultation that may emerge on this topic. We do, however, note that consultation would be essential and that it would be inappropriate to proceed on the assumption that there are no policy issues in extending the Panel's rules into the holding of derivatives positions in circumstances other than a bid.

We attach a link⁵ to our response to the main Takeover Panel consultation on the subject, which gives a fuller exposition of our reasoning.

7. Risk

It would be helpful, in our view, to stress that there are risks to the regulators' objectives which logically would take a higher priority, for instance fraud in relation to a fund.

As regards financial performance risk, DP05/3 correctly states (para 2.4) that riskiness exists on a continuum, rather than being a binary ('on/off') phenomenon. The paper could, of course, have mentioned that greater risk (in the sense of volatility) may well be a corollary of greater potential reward; and that it is the balance between the two that should be analysed to give a complete picture of any investment.

8. Conclusion

As stated above, we do not believe that at present the activities of hedge funds warrant any new regulatory measure. We agree that use of derivatives is often a characteristic of hedge funds but do not believe that this – or any 'stylistic' aspect of their activities – is a sound or a helpful definition. We agree that retail investors need particular protections but argue that, as long as existing types of protection are properly deployed, the ability to access hedge funds or 'wider-range' investment products should not in itself be problematic.

We remain concerned at possible extensions of disclosures relating to cash-settled derivatives.

⁵ See <http://www.isda.org/speeches/pdf/ISDA-PCP-2005-1-Response2-28-05.pdf>