



The Standing Senate Committee on Banking, Trade And Commerce in the Matter of Hedge Fund Regulation - Transcript

OTTAWA, Wednesday, November 8, 2006

Christopher Guthrie: On page 5 of the brief, we indicate a particularly important viewpoint on what hedge funds can contribute to investment management, and as well to the economy. The first point was the most important. **One of the benefits that hedge funds can offer to investors is a consistent and customizable risk profile.** This first sentence turns the world a bit on its head. The flexibility in the use of leverage and instruments leads to enhanced risk management. It would be impossible for us to do what we do without using leverage and without doing it in the structure of a hedge fund. Our objective is to align our risk with the investor's risk. It enables us to specify to target risk budgets. It is in this way that hedge funds actually lower systematic risk. It is an important component. I have seen some of your transcript struggling with the systematic risk. On hedge fund side, we would come down importantly on the fact that hedge funds are unique enough by virtue of their construction that as a group, they very rarely pose any systematic risk, certainly nothing compared to other asset classes which are dealt with in the next two points.

A more consistent return profile, hedge funds have the ability to create consistent return profiles that are different from what we are typically used to or where we are a victim of the business cycle or the asset cycle or the bubble cycle. Typical asset classes have extreme dislocations. These things can rarely be avoided and they are never one person or one industry's fault. They just happen. Why do Japanese equities go up for six years and then go down for 20 years? Why does Nortel go up and down like a yoyo? Why is Calgary real

estate 10 times more expensive than it was? In our opinion, these are systematic risks and they are not necessarily due to hedge funds.

The **third point is true diversity and asset allocation.** Over time, as markets have become more sophisticated, we can buy pre-packaged Turkish equities. We can participate in all kinds of markets in an efficient manner. The diversification that used to be available by participating around the world is no longer available. Our markets are now linked like they were never linked before. Systematic risk appears to be accumulating in traditional asset classes as far as we are concerned, not necessarily in hedge funds. I have by appendix, either on your way out or on your desks, small presentations that we put together showing the data on how asset classes are becoming more correlated to one another; that European stocks and U.S. stocks are trading essentially in precisely the same patterns.

The **fourth point is better matching of liabilities.** It is important on the pension side, in particular for many of our clients who are struggling to meet either long-term, fixed or low-risk liabilities, to have another option other than bonds, especially in this environment where bond yields are quite low. I know senators have touched on this, but the Canada Pension Plan does have a fairly active program of what they call "active overlay," which is a hedge fund, by any other name, inside its program. These are not new things to all sophisticated participants in the market.

We also thought it was important to highlight that we are extremely regulated by a number of different forces. On slide No.6 we refer to investors, service providers, regulators and the public. In particular, with respect to regulators who now have additional

resources which they never had 10 years ago, I believe the OSC is now a large profit-making venture. They have resources to audit and to control like never before, and to come here and present, which they have done.

On slide No.7, senators can see the points that I deemed important to address: The blind trust comment. In our case, because we are registered and all our products, although exempt, are still in the public eye, we are governed by our offering documents; by subscription agreements; by due diligence, which is onerous and extensive and much more than in the regular asset-management space; and by monthly reporting to clients.

On slide No.8 I have shown some of the matrix of oversight that we have. In Canada we have created a large, robust matrix of oversight. There are investors and service providers, of whom there are many to a traditional hedge fund that are important to know about, such as prime brokers and custodians. Prime broker is the term used for a hedge fund custodian, allowing you to borrow shares to effect your short-selling or your margin. All large IDA firms have prime brokers and are making a tremendous amount of money. The key is that they provide oversight and it is their capital. Under IDA regulations, margin is constrained and it is not possible to borrow more than IDA regulations allow.

Fund administrators, such as Citigroup Canada, Royal Trust, Citco or CIBC Mellon. These include traditional custodians, who have added to their arsenal of products and fund accountants that allow us to count the assets, in our case on a daily basis, and distribute those net asset values to the public or to clients.

I believe that you have all of the regulators here. They now have resources and, from a personal perspective, we spend a great deal of time interacting and having them in our office. The audit process that the OSC goes through is extremely extensive and lasts one to two months, depending on how many people are in the process. It takes place once every two or three years depending on your risk as a firm. **All investment counsel & portfolio managers have been audited in Ontario at least once, and perhaps a second time.**

A little different from the U.S. is the concept of proficiency requirements, which the U.S. has not added yet to their registration. Under the Ontario Securities Registration, you have to be seen as proficient, which involves a CFA course and a large standard of practice handbook that governs all of our behaviour on a regular basis. There are annual audits, semi-annual audits and regulations, so it is fairly large. I mentioned slide No.10, the CFA designation, and some of the

other market exchange regulations of which we are a part. As well, there are the one-offs that still linger: FINTRAC for money laundering, PIPEDA for personal information, et cetera, and other various policies. Regulators come through the office or monitor your website to ensure that those policies are in place. You are in frequent contact with regulators.

The public provides a degree of review because our asset classes are posted in the newspapers on a weekly basis. I will pass it over to Mr. Kaul. We thought it would be useful for the committee to look at the hedge fund industry to understand how the hedge fund asset pie fits inside the "investable" asset pie. We brought some market sizes with respect to derivatives and other instruments to give you an idea how small it is.

Arun Kaul: Gathering data is one of the challenges in the industry. Various providers track hedge funds and the assets. It is a self-reporting industry so there is a fair range of data available.

The intent is to show the relative size of the hedge fund industry vis-a-vis the financial markets. The data we are using on the hedge fund space is from a firm called Hedge Fund Research (HFR), based in Chicago. They had the estimate of industry assets at U.S.\$1.1 trillion as of the end of 2005.

Senator Grafstein (Chairman): The last material we received was from Senator Arlen Spectre, former Head of the Judiciary Committee in the United States. In a hearing in June 2006, the reference we heard was that the amount was \$1.5 trillion to \$3 trillion. There is a big difference between \$1.5 trillion and \$3 trillion but those were the numbers that he had received last June. If the assets total \$1.1 trillion as of 2005, and assuming there is an accumulated increase of one-third, that would hit the lower number of his estimate.

Mr. Kaul: It is definitely an issue in terms of gathering the data. I would suggest to senators that there is certainly a great deal of double accounting in the industry in the sense that fund of funds, who would track their numbers, also own single managers, who would track their numbers also. Thus, there is double accounting. Fund of funds are approximately one-third of the assets in the industry.

If you try to define "hedge funds", it would be difficult to reach a consensus. I have not seen anything as high as \$3 trillion in the data that we follow. The advantage of HFR is that they have been around for 15 years and have had a stable and consistent categorization of hedge funds.

The other issue that comes into play is that hedge funds use leverage. When individuals report their assets, even in the hedge fund industry, there is no

agreement on what is leverage and what is not. Many people use leverage but do not call it leverage. There is room for determining the real asset number. For now, we have used \$1.1 trillion. I will provide some perspective on the growth of the industry. In 1990, the annualized growth rate was approximately 25 percent. If you go over the last five years, the annualized growth rate has been approximately 15 per cent at the global level.

There certainly have been many participants who are non-U.S. based. Going back 10 or 15 years, the advantage the industry had is that it was largely U.S.-based. The reporting was easier from the perspective that they were all from the U.S. You now have hedge funds that are based globally, for instance, in Europe, the Middle East, Australia and emerging markets. It is more difficult to gather the numbers. It is possible that it is higher than this. Having said that, when you put it in context, it is still a fairly small percentage.

If you look at the total market cap, you will see that global equity markets are around \$41 trillion. This is data from the World Federation of Exchanges and is, again, for the end of 2005. **Hedge funds are under 3 per cent of global equity markets.**

If you look at the U.S. bond market, you will see it is larger than the U.S. stock market from a market cap perspective. If you put stocks and bonds together, you are looking at roughly \$3 trillion against 80 for traditional assets of stocks and bonds. If you look at the derivatives market, the notional value today is greater than \$300 trillion. Hedge funds are certainly involved in derivatives, but they are by no means the main participants in terms of the derivative market globally.

The Chairman: If you compare the growth of the overall market of \$41 trillion, at what rate has it been growing per year? I see your number is 35. We have been given anywhere from 15 to 30 per cent, but let us take 25 per cent as a compound rate for hedge funds, per se. What is the growth of the overall market? Would it be fair to say that it is between 10 and 12?

Mr. Kaul: That is probably reasonable. I would adjust that by saying what is happening at the global level is that more countries are participating in the global public markets. Thus growth rate is probably higher if you add in the new emerging markets as new companies that were never listed before. Take Chinese IPOs for example. The growth rate is probably higher in some regions. Ten to 15 is reasonable to use with certain regional exceptions.

From a Canadian perspective, the data everybody is quoting is from Investor Economics of June 2004. That

is approximately \$26 billion in Canadian assets. That breaks down through hedge funds, fund to fund and also single hedge fund providers like ourselves.

Even in context in Canada the data we have on the pension fund assets, according to the Canadian Pension Fund Directory, a publication produced through Rogers, is around \$800 billion. According to their reports, they have roughly a 1 per cent exposure to hedge funds, which is about \$10 billion. They are self-reporting. That is the largest 1,000 pension plans in Canada.

Mutual fund assets as measured by IFIC are around \$70 billion. IFIC is a self-reporting organization. Some firms have said that that number is probably understated.

Looking at derivative assets in Canada, when the Montreal exchange representatives were here, they quoted \$600 billion. Thus I am using that number for derivatives in Canada.

The point simply is that if you look at hedge funds as part of the global marketplace, they are not very large in terms of the asset size. When you look at hedge funds specifically we ask that they be treated in context with their overall size in the marketplace.

Trading activity is a different point. However, we did not bring any statistics with regard to that. Certainly, the trading activity would have a different bias because hedge funds will typically tend to trade a bit more. That is the context on the data. The derivative data we have is from the Bank of International Settlements. Most of this data is publicly available on all their websites.

Mr. Guthrie: The sheer magnitude of the size of the other asset classes means that if you try to regulate the content of one of them, the others just swamp the effort. We have to try them all or none. It is impossible to squeeze one asset class while others thrive in an unregulated environment. In the case of most of these assets, that is how they are.

Mr. Kaul: In some cases there might be competition between a pension fund or an investment bank and a hedge fund for the same type of strategy. The investment bank, which is not precluded from running a particular strategy, could run a strategy and a hedge fund may not be able to if they were so restricted. Again, they would be doing the same thing.

To touch on systemic risk, which is the next page, it is important to differentiate between stock-specific risk or non-systematic risk and actually systemic risk. The issue here is that stock-specific risk is diversifiable. The main point is that as long as investors can

diversify their risk, then you have an active and properly functioning marketplace.

I want to make reference to Amaranth because it has come up. If you look at the Amaranth loss, it is better viewed as stock specific or issuer specific as opposed to systemic in the sense it is really just an issuer-specific issue. The challenge with hedge funds is that there is tremendous latitude on what they may or may not want to invest in. The investor, the regulator and the policy maker may have a harder time knowing what the exposures are. Again, if you see that as non-systematic risk, then the real risk is that as long as there are many participants in the marketplace who are free to invest as they want, then you have a fairly stable market with individuals on both sides of the trades.

The point with Amaranth is that you could look at other traditional investments and have losses that were greater than that, and these investment products are readily available. For example, look at Nortel as a stock. It had a 35 per cent decline in one week in the month of September 2000. That was roughly a \$46 billion loss for the stock for that one week. The two should be viewed as the same, i.e. issuer-specific risk, both diversifiable, as long as the investor understands that.

The only area that is not regulated is the specific content of the strategy. From our perspective there are no rules in terms of how we want to design the strategy, which we think is a great benefit of the area because it allows investors to choose exactly what they may or may not want. It could be a risk budget. It could be someone as aggressive as an Amaranth or someone with a more consistent or non-diversified approach. Many of those features are available in the marketplace today.

With that I will pass it over to Mr. Guthrie to conclude.

Mr. Guthrie: We have our opinion. Obviously, we have stated most of it.

From our perspective, over a 10-year cycle in Canada, regulations have grown, matured and have become a positive force on the industry. The material we have recently seen out of the OSC shows an

increasingly positive vision of how to regulate. There is a lot of research going on. They have resources now which they did not have 10 years ago. We have to give them time to continue their job. In our opinion, they are doing a fairly good one.

Deficiencies are being addressed one by one on the distribution side. They are certainly being addressed by that matrix of parties, the IDA, the OSC, the exchanges, et cetera.

Sophisticated investors drive the largest part of the market. In this case, the growth of hedge funds at the institutional level will soon swamp whatever we can sell on the retail side. It is smaller already in Canada. Institutions are getting into it at an ever increasing rate. We do not worry too much about them, unless the risks are clustered.

We do like cost-benefit work on all regulations. This industry is probably the most competitive industry in the world. That is a little self-serving, perhaps. It is hard to think of other industries where people go in and out of business as quickly as hedge funds based purely on their raw processing power.

In Canada, we have a small, nascent industry that is now competing on a global scale, particularly with the elimination of the Canadian content restriction. We are now facing competition from the large global investment management firms. Any help we can get in terms of our regulation vis-à-vis the others would be much appreciated. It is a different slant on regulation. There is no reason why we have to have the tightest or most constrained market necessarily, if we think the industry is worth supporting. It is not just the hedge fund but the whole investment management industry in this case that faces a large quantum shift in the next few years.

The U.K. is now reworking the whole principle of regulation to principle-based. When you get to the size and the complexity of the instruments we have to leave prescription and just enforce a universal principle, either distribution or content or know-your-client, rather than trying to set up rules for each asset class where people jump from one regulatory regime to another to arbitrage the advantages between them.