

HOUSE OF COMMONS
TREASURY COMMITTEE

BANKING CRISIS - HEDGE FUNDS AND SHORT SELLING

Tuesday 27 January 2009

MR ANDREW BAKER, MR DOUGLAS SHAW, MR PAUL MARSHALL, MR CHRIS HOHN
and MR STEPHEN ZIMMERMAN

MR PETER CHAMBERS, MR ALAN GRISAY, MR RICHARD SAUNDERS, MR PETER
MONTAGNON, MR ANTONIO BORGES

and MR DAVID PITT-WATSON

Oral Evidence

Taken before the Treasury Committee

on Tuesday 27 January 2009

Members present

John McFall, in the Chair

Nick Ainger

Mr Graham Brady

Mr Colin Breed

Jim Cousins

Mr Michael Fallon

Ms Sally Keeble

Mr Andrew Love

John Mann

Mr George Mudie

John Thurso

Sir Peter Viggers

Memorandum submitted by the Alternative Investment Management Association

Examination of Witnesses

Witnesses: Mr Andrew Baker, CEO, Alternative Investment Management Association, Mr Douglas Shaw, Managing Director and head of BlackRock's Proprietary Alpha Strategies Team, BlackRock, Mr Chris Hohn, Founder and Chief Investment Officer, The Children's Investment Fund, Mr Stephen Zimmerman, Chairman, NewSmith Capital Partners, and Mr Paul Marshall, Chairman, Marshall Wace LLP, gave evidence.

Q236 Chairman: Welcome to our hedge fund investors' inquiry. This is part of our banking inquiry. Please introduce yourselves for the record.

Mr Baker: I am Andrew Baker, chief executive of the Alternative Investment Management Association which is the global trade body for the hedge fund industry.

Mr Marshall: I am Paul Marshall, chairman of Marshall Wace. I am also a founder trustee of the Hedge Funds Standards Board.

Mr Shaw: I am Douglas Shaw, managing director of BlackRock where I help manage the single strategy hedge fund business.

Mr Hohn: I am Chris Hohn, managing partner of the Children's Investment Fund.

Mr Zimmerman: I am Stephen Zimmerman, chief executive of NewSmith Asset Management. We look after a combination of long only and single strategy hedge funds.

Q237 Chairman: Welcome to this inquiry. Mr Shaw, to start with you, do you think that the UK regulatory system for hedge funds as currently designed will prevent a Madoff or Nadel-type failure, or is it only a matter of time before we see a similar case here?

Mr Shaw: I think UK fund managers, of which hedge fund managers are a part, are generally quite happy with the regulatory regime under which they operate. UK-based hedge fund managers are regulated in exactly the same way as other fund management companies. I point out that the degree of fraud in fund management is extremely low and very rare.

Q238 Chairman: To cut to the chase, you do not think there will be a Madoff and Nadel-type case here?

Mr Shaw: I do not think one can ever use the word "never".

Q239 Chairman: Do you think regulation will prevent that?

Mr Shaw: UK regulation has been very much more successful in preventing fraud than other forms of regulation.

Q240 Chairman: How damaging do you think those episodes are for the hedge fund industry?

Mr Shaw: Extremely damaging. Issues of fraud have damaged the reputations of some hedge fund companies and come as a great shock both in their longevity and the apparent, although as yet unknown, scale of the supposed fraud that Mr Madoff appears to have perpetrated.

Q241 Chairman: Mr Hohn, do you agree there are two ways in which you can be thought of as a systemic risk: when a hedge fund failure causes a bank to fail or lots of hedge funds fail together causing significant damage to the market and assets are then sold off, depressing asset prices?

Mr Hohn: In the past there has been one example of that in the case of long-term capital where a hedge fund was allowed to become too big and leveraged. That caused problems in the markets many years ago. Today I do not see that as a particular issue. I do not think that hedge funds in general have excessive leverage, so I do not see that issue as having a high probability.

Q242 Chairman: Mr Zimmerman, in paragraphs 7 and 8 of its memorandum the Hedge Fund Standards Board say there are two ways in which hedge funds could potentially inflict harm on banks: a hedge fund failure destabilising a bank and a run on hedge funds. Do you think that is the case? There are two ways in which you can be thought of as a systemic risk: a hedge fund failure causing a bank to fail, as I mentioned to Mr Hohn, or lots of hedge funds failing together, causing significant damage to the market?

Mr Zimmerman: I think that is very unlikely. As Mr Hohn has already said, the evidence suggests that there has been only one failure in the hedge fund world. Given the reporting regulations and various disclosures that take place, that is extremely unlikely.

Q243 Chairman: Mr Marshall, do you think the recent crisis has increased the risk of either of these events occurring?

Mr Marshall: I very much agree with the statement you have quoted. I think the recent crisis has led to a sharp de-leverage of the hedge fund industry, triggered primarily by Lehman Brothers. The Lehman Brothers event created risks for the hedge fund industry, but I think that broadly that is now behind us.

Q244 Chairman: Douglas Shaw, do you think that when hedge funds reach a certain size they should be directly regulated by the FSA?

Mr Shaw: I think there is a case for that, and you may already see that happening. As I understand it, the FSA is in much more frequent contact with the 40 largest UK-based hedge fund managers and are managing them on a relationship basis. We have had some tumultuous times over the past year, but hedge fund managers probably worried more about their credit risks with banks than maybe banks did about their risks with hedge funds.

Q245 Chairman: Mr Baker, how many hedge funds are there in the UK?

Mr Baker: According to FSA figures, the number of management firms operating here is in the region of 400 to 450 and of those some firms operate single funds and some multiple funds. No one

knows for sure the exact number but it is thought that there are in excess of 1,000 managed by UK-based managers.

Q246 Chairman: But you have only 33 members on the Hedge Fund Standards Board.

Mr Baker: I do not represent the Hedge Fund Standards Board but the trade body AIMA.

Q247 Chairman: But the Hedge Fund Standards Board has only 33 members.

Mr Baker: It has been in existence for less than 12 months and currently it has 34 signatories. I believe that one more signed up yesterday, so it is quite early days. The managers had only to prove that they had signed up by 31 December, so there is a significant pipeline of people who are about to sign up.

Q248 Chairman: Are there any here who are not members of the Hedge Fund Standards Board?

Mr Zimmerman: We are not members of the board. We are looking at whether we should join. Because of the nature of our business we are already members of another association. We think that voluntary industry initiatives are a very important and valuable way to promote self-improvement. At the minute we are looking at the merits of joining.

Q249 Mr Fallon: Mr Hohn, Sir Andrew Crockett, former chairman of the Financial Stability Forum, has given evidence to us that in disturbed conditions hedge funds add to market volatility and the "herd" phenomenon can accentuate market movements and destabilise market dynamics. How do you plead?

Mr Hohn: I think that in some circumstances that can occur but it can occur through general panic and long investors also panic. After Lehman Brothers there was a general panic of all investors, I think.

Q250 Mr Fallon: For example, he suggested that highly leveraged funds could be induced to undertake forced sales in times of systemic stress and that simply added to problems in the market.

Mr Hohn: High leverage can be an issue, but it is not the case that all hedge funds have high leverage; many have low leverage or high levels of net cash.

Q251 Mr Fallon: Mr Shaw, is there not a case for better regulation of those hedge funds that are systemic and significant?

Mr Shaw: Yes, and I think that is already happening, but FSA's own published recently showed that the degree of hedge fund leverage as employed by the 20 largest hedge funds in their domain appears to have been falling significantly ever since October 2005. Therefore, the evidence such as it is suggests that hedge funds were probably reducing risks as they foresaw troubles ahead.

Q252 Mr Fallon: Mr Marshall, does the regulator have sufficient data about the assets and liabilities you hold to regulate you properly?

Mr Marshall: Before I answer that question perhaps I may add to what my colleague said about leverage. The leverage in the hedge fund industry fell in 2008 from 1.7 to 1.4 times. That is the aggregate for the industry. If that is compared with 40 or 50 times for the banking industry that gives you a measure of the difference in the problem. That does not mean there cannot be an

individual hedge fund with very high leverage as we saw in 1998 with LGCN where it was 33 times. There can be isolated funds with significant leverage. We would welcome the work that is being done to look at whether special types of leverage limits can exist for those types of funds. Do I think that the regulator gets enough data on hedge funds? At the moment I understand that they receive from the prime brokers formally every six months - obviously, they can receive it on a daily basis - aggregated data for the top clients of all the prime brokers. In the US nothing of that kind exists. You could move to a more formal process of aggregating data through the prime broker to provide that information to the regulator and then co-ordinate that on a global level.

Q253 Mr Fallon: Would you do that for the whole population of hedge funds or just for the systemically vulnerable ones?

Mr Marshall: The beauty of doing it through the prime broker rather than asking individual hedge fund managers to provide the data is that you get a much more effective aggregation.

Q254 Mr Fallon: Do you support that, Mr Baker?

Mr Baker: I agree entirely with what Paul Marshall has said but I add one other point. The FSA has access to any data it wishes to ask for. Part of the issue is that we are dealing with a global market, global players and capital flows within the global market. It is very important that whatever information is put in place in one country is comparable with the information gathered in other countries. We probably all know that America and the UK account for the vast majority of hedge fund assets, so if there can be agreement between the US and UK authorities about what information of systemic importance needs to be gathered and how best to gather it the hedge fund community is ready and willing to provide whatever is asked for.

Q255 Mr Fallon: You appear to be telling us collectively that you are not the problem but if you were you are now slightly less of a problem?

Mr Baker: The industry is not as large as it was, so by definition it has de-leveraged and the assets it manages have come down. To embellish a point made earlier, a lot of issues that crop up in capital markets are put into a generalised bucket called the hedge fund problem. I would be so bold as to say that if all hedge funds ceased to exist tomorrow these issues would not go away because hedge funds are not the only entities that operate in the capital markets, use these techniques and are monitored by the regulators. It is crucial that more data is captured so we can work out which firms are operating in which markets.

Q256 Chairman: You mentioned the availability of information, but worldwide assets under the management of hedge funds are estimated to be over \$225 billion and they are held by 1,100 hedge funds. Can I ask Mr Marshall what his assets under management are?

Mr Marshall: It is €5 billion.

Mr Shaw: BlackRock deals with a wide variety of assets - mutual funds, pension funds et cetera - and as a whole manages \$1.31 trillion, of which only \$8 billion are hedge funds. Therefore, arguably my company manages more money than the entire hedge fund industry.

Mr Hohn: We manage \$9.5 billion.

Mr Zimmerman: In our case it is £2 billion, of which one third is in hedge funds.

Q257 Sir Peter Viggers: Perhaps I may ask the four practitioners to answer in a word how important short selling is to their activities.

Mr Marshall: Integral.

Mr Shaw: It is important for our hedge fund activities.

Mr Hohn: Limited but helpful.

Mr Zimmerman: Important.

Q258 Sir Peter Viggers: What is the difference between covered short selling and naked short selling in terms of market efficiency, looking at it entirely from the point of view of market efficiency and profitability?

Mr Shaw: I do not think that a well-managed hedge fund management company would engage in naked short selling. I do not believe that the practice is prevalent. Naked short selling occurs where a short sale is made in the market without any realistic hope of delivery. It is not thought that that is a common practice. If it was the amount of settlement failure in UK financials or stocks as a whole would be very high. I am not aware of any data from, say, CREST, to suggest that the quantity of unsettled bargains is high or that it represents any kind of systemic risk.

Q259 Sir Peter Viggers: I have been told by a banker whom I know and trust that there was substantial naked short selling of Northern Rock before it went down. Can you comment on that?

Mr Shaw: I have not seen any evidence of that. Perhaps that is a question for CREST which would have data on unsettled bargains like that.

Q260 Sir Peter Viggers: Was the FSA right in banning short selling for a period in September?

Mr Shaw: In one word, no.

Mr Zimmerman: No. If you look at what happened during that period of time and subsequently when they fell markedly the evidence has not made that out.

Mr Marshall: You may have had submitted to you evidence commissioned from an independent research source by the London Stock Exchange which shows that the effect of the short sale ban - this is only up to 6 January - has been to reduce liquidity significantly in the concerned stocks, increase transaction costs by 150% and create a marginal increase in volatility in those stocks. If you look at what happened to the share prices in the period, Barclays fell by 75%, Lloyds by 66% and RBS by 84%. You will see that there was a clear impairment of the facilitation by the market and also no observable impact in reducing the decline in the shares.

Q261 Sir Peter Viggers: How are the reporting requirements on financial stocks which continue until June affecting you?

Mr Shaw: We have to employ somebody and develop resources to make sure we meet our reporting requirement. That was a task we did not have before and so there is an operational burden that did not previously exist. At the margin I would have thought it would hinder short selling because a short seller must ponder whether he wants his name and position to enter the public domain. Maybe he does or does not, but now it is something he must think about whereas before he did not.

Q262 Sir Peter Viggers: Are your activities being unduly restricted?

Mr Shaw: They were restricted in the period of time when the ban existed.

Q263 Sir Peter Viggers: Mr Baker, your association submitted to us a memorandum, for which we are grateful. It says: "A disclosure regime related to short positions and restrictions on making short selling is the way forward." Would you like to expand on that?

Mr Baker: We believe very strongly that it would be helpful to have a common approach around the world to the whole subject of selling. It would include a number of elements, the two principal ones being some kind of restriction on naked short selling and a disclosure regime. The FSA will be publishing a fuller consultation paper. What we have seen so far is strictly in response to the temporary selling ban. That paper will be published in the early part of February. An integral part of that report will be to look at the merits of a disclosure regime and, in particular, how this issue is handled in other parts of the world. We as an association recognise that there is significant public interest in this issue and to go back to a time when short selling had no disclosure regime attached to it is probably not the way forward, which is why we have embraced the idea of disclosure in aggregate to the marketplace. What I mean by "in aggregate" is that the total short interest of shares in any particular company would be publicly available information but individual positions held, say, by the managers on the panel would be disclosed to the regulator but would not themselves be in the public domain. We feel that it does not serve the market's interests to know the identities of the short sellers.

Q264 Nick Ainger: This morning the FT is carrying the story that Paulson & Co, one of the world's biggest hedge funds, made more than £270 million shorting RBS shares over the past four months. All four hedge fund managers in response to Sir Peter have accepted that shorting is a significant part of their income and turnover. I ask each of you whether your funds have been shorting British banks.

Mr Marshall: Not in the recent period, but we were short and long with British banks during 2008.

Mr Shaw: In 2008 we bought British banks and were short in British banks.

Mr Hohn: In our case it was relatively minor last year.

Mr Zimmerman: We have done both. Yesterday I was just looking at some statistics which are quite illuminating. I think that at the end of 2006 and beginning of 2007 the Royal Bank of Scotland was priced at around £6 and it is now 16p or whatever it is. It was the sixth largest company in the country, or 3.4% of the index. Barclays was over £71/2 and is now 90p or so and it was the seventh largest company at 21/2%. You can see the huge destruction of wealth that has taken place in these companies over this time. I hasten to add that I do not believe that is down to the short selling of their shares.

Q265 Nick Ainger: The public who two years ago had considerable confidence in the British, arguably the world, banking system felt that their savings were safe. That is certainly not the case now. Among the people they blame are bankers but also hedge funds. Do you think stories like this where an individual hedge fund on the back of short selling makes £270 million profit on the problems of a bank like RBS will restore confidence upon which at the end of the day the whole system is dependent?

Mr Marshall: It is very important to put these stories in their context. This headline is somebody's attempt to estimate what Paulson made on the short position over the six-month period in which he was reputed to have held it. They do not allow for any long position that he had against it. For all we know, Paulson is more of a dedicated short seller.

Q266 Nick Ainger: But the important thing is that here is a story which will be repeated across the tabloids. Is that type of story, which is likely to be repeated with other hedge funds revealing that they have made very substantial profits from the failures of British banks, going to help to restore confidence in the system?

Mr Marshall: No, it is not, but I think it is a very partial reporting of what is actually going on. The word "hedge" means that we both hedge the risk and try to preserve capital. The primary responsibility of a hedge fund manager is to his investors and, therefore, to try to maintain a stable performance of the funds through volatile times. Certainly, in the case of Marshall Wace that is how we use hedging. Typically, there will be shorts and longs in the same sector. You can extract from that one piece of information which says that for one particular stock over a particular period of time someone has made x profit, but that is a very partial view of what is going on. If we look at the aggregate position last year, the industry lost - we are not proud of it - 18%. The industry is not sitting there making vast fortunes at the expense of the British public. Somebody said to me yesterday that to blame hedge funds was like blaming passengers for a bush crash. The hedge funds are themselves suffering from the financial environment. Occasionally, some of them make profits and that is taken out of context and is, I think, misleading.

Q267 Nick Ainger: Perhaps the other fund managers would like to comment. Do you not appreciate that there is a real issue of confidence? You have said you do not believe that this is a fair reflection of what has been happening, but the fact remains that shorting bank stocks is a highly contentious issue particularly for the shareholders of those stocks and people who see what has happened to Barclays in the past fortnight, for example the huge volatility and so on. They now believe that that is down to short selling, the lifting of the ban and so on.

Mr Shaw: The headlines and stories are to some extent beyond our control. We very much welcome the opportunity to appear before you today, to be transparent with you and provide evidence to the Committee in oral and written form. We share the concerns of the wider population as a whole, but in investigating the banking crisis you will find many features which contributed to it. Some hedge funds as we read today in the FT have made profits from the decline in bank share prices. They had a legitimate purpose to serve in trying to meet the objectives set by their clients, but I do not think it is right to say that they made money out of the misfortune or concern of others. They felt that share prices in banks were too high; they had an expectation that those share prices would fall, but the fact that prices did indeed fall does not mean they made the share price fall.

Mr Baker: Mr Ainger, I think you put your finger on it by your use of the word "confidence". What Barclays did yesterday is a very good illustration of what happens when banks make statements to the marketplace about the nature of their balance sheets. That is what gives confidence. There is transparency and the published balance sheets are a true and fair reflection of the assets held. The share price rose by up to 75% at one point, so anybody sitting with a short position over that period - this is something that does not get into the newspapers - would have been ferociously squeezed and lost a great deal of money. Therefore, "confidence" is exactly the right word. If there is transparency in the bank's balance sheets confidence will return and share prices will recover.

Mr Zimmerman: If I may turn the question round slightly, go back to the dot.com boom many years ago. We had a number of companies whose share prices rose incredibly sharply to ridiculous levels.

Because there was such a small free float in those companies no shorting took place. Unfortunately, investors lost money in those companies because there was no proper price discovery. I totally accept your point and endorse what Mr Shaw said; these are worries and it does not help confidence, but I think we have to go back to the root causes of why these companies have performed so poorly.

Q268 Chairman: Do you accept that as an industry you have a PR problem?

Mr Marshall: Yes.

Q269 Chairman: You remind me of the time when representatives of private equity came before us. Everything seemed to be okay and it was the fault of everybody else. You suffer from the present economic environment like everybody else, but do you not accept that with stories like this where £270 million has been made in the past four months and the taxpayer has put billions of pounds into the banking industry the hedge fund industry is seen as gambling against the taxpayer? What PR message do you give to assure taxpayers that that is not the case and that the billions they have put in has not been eroded by hedge fund speculators taking away the wealth of the banks?

Mr Baker: We fully accept that there is a legitimate public interest in this issue and that our industry undoubtedly has an image problem, and it is one that we are very keen to put right. Part of the issue, as I am sure you appreciate, is that the industry does not do just one thing.

Q270 Chairman: Private equity came along and afterwards set up a code. Sir Mike Rake is now chairing that and is writing to the Committee to say that progress is being made. Sir Andrew Large is chairman of the Hedge Fund Standards Board, but if the board has only 33 members it is not making much of a dent. There is a view that what the industry is doing is snubbing the public and making shedloads of money out of taxpayers at a time when every single penny they have put into institutions should be preserved. There is a PR problem here. What measures do you have to deal with it?

Mr Baker: One of the things we are very keen to do is to have discussion with international regulators to make sure that there is a common approach to short selling.

Q271 Chairman: There is still a PR problem and you have a big hole to deal with. Mr Baker, you said that short positions should be declared to the regulator but not to the market. If you were long you would have to declare that to the market, so why is there a discrepancy? If disclosures are beneficial for banks why do we not go further on this? Mr Marshall, do you think that is a good point?

Mr Marshall: Yes, I do.

Q272 Chairman: Why do we need to drag it out of you?

Mr Marshall: Our primary recommendation is for aggregate disclosure. Obviously, the reason hedge fund managers resist specific short disclosure is because it can work against their positions, but there is a good case for a symmetric disclosure of longs and shorts. At the moment the policy is that at 0.25% you have to disclose a short position and at 3% you disclose a long position. I think the primary reason for disclosure of short positions is one of financial stability. That is really an aggregate rather than fund manager issue and that is why we are more in favour of a policy of aggregate disclosure.

Q273 John Thurso: Mr Marshall, I want to talk about regulation. In an answer just now you said that the point of a hedge fund was to hedge risk and therefore to conserve wealth on the basis, I assume, of absolute return. As the Chairman has just said, the public view of the hedge fund industry is that they are an opaque bunch of spivs who gamble with public money. To what extent should regulation be brought in to rectify that?

Mr Marshall: We do have a problem with our public image and I think the best way to address it is to engage in this debate, and we are very grateful to be here to have that opportunity. One of the things I am keen to get across is that the UK has a very good regulatory regime for hedge funds and it is different from the regime in the United States.

Q274 John Thurso: Is it good because it is light touch for you?

Mr Marshall: No. It is good because it treats hedge fund managers in the same way as all other managers. When you want to set up a hedge fund management company in the United Kingdom you must go through a lengthy authorisation process during which your business and investment plans are considered, you are screened to ensure that you are a fit and proper person and so on. In the United States less than 50% of hedge fund managers are registered with the SEC. When you are registered with the SEC the amount of oversight is very limited. To come back to the very first question, that is why a Madoff-type situation is very unlikely here. We have a competitive advantage in terms of our regulatory regime and in relation to financial stability.

Mr Shaw: Yesterday I met with an insurance company. There is a market for insuring yourself against the fraud of a fund manager, not necessarily a hedge fund manager. Of the 67 instances of known and reportable hedge fund fraud over the past decade every single case arose in America. That insurer could not show me one instance of hedge fund fraud in the UK or Europe. Therefore, it is not as if the FSA is necessarily light touch; it is more that it is principles-based which means that, frankly, there are fewer rules. There are 11 principles rather than a whole set of complex and prescriptive rules. That adds a little bit of uncertainty to our day-to-day jobs as to precisely how the rules are to be interpreted, but to have a duty of care to put our clients first and have prudent businesses is a very good starting point.

Q275 John Thurso: Am I right in understanding that basically what you are saying is that there is no difference in the regulation of fund manager? Whether you fall into what is called "hedge" as opposed to classic fund management, all investment fund managers are regulated in the same way in this country?

Mr Marshall: Yes.

Mr Zimmerman: Yes.

Q276 John Thurso: Why then in the submission of the Hedge Fund Standards Board to the inquiry do you say that by contrast hedge funds rely on sophisticated investors who do not need the protection of regulators?

Mr Marshall: I think that is a reference to the fact that a significant number of the funds managed by hedge fund managers are offshore primarily for tax reasons.

Q277 John Thurso: So, the manager sitting in his office in the square mile is regulated but the money he manages offshore is not?

Mr Marshall: The offshore funds are more likely to be regulated.

Mr Shaw: For example, in Luxembourg.

Q278 John Thurso: This seems to me to be slightly a matter of angels on a pin. What is the difference between regulating the activity of a manager and regulating what is happening to the money somewhere overseas?

Mr Marshall: I think there is a case - I know that the Financial Stability Forum is considering it - for looking at how offshore funds are regulated and whether they should be subject to a greater burden of regulatory supervision.

Mr Baker: All of the decision-making is done by the managers who are based onshore. Every decision they make which results in a trade or the purchase and sale of an asset is controlled and regulated by the FSA.

Q279 John Thurso: To what extent is it important to regulate the assets and the products in which the managers are dealing as opposed to their activities?

Mr Baker: Regulation tends to break down into two components. There are aspects of regulations which deal with systemic risk - stock markets being destabilised - and aspects that deal with investor protection to stop mis-selling and the wrong people buying the wrong products. The vast majority of what we have been talking about today is in the sphere of financial stability for the reason that hedge funds tend to have very high levels of minimum investment. That is intended as a deliberate deterrent to retail investors. That statement has been made in the Hedge Funds Standards Board because investor protection issues are not the primary purpose of that document. The primary purpose is to raise the standards of investment practice by managers and ensure that systemic issues do not arise.

Q280 John Thurso: When we conducted our inquiry into the Northern Rock collapse we took evidence from a number of very senior chairmen of banks. One matter that emerged from it was that they did not wholly understand the instruments of debt they had allowed their staff to play with. If I remember rightly, it was the chairman of Goldman Sachs who said that due diligence was, frankly, not up to scratch. Is that an issue in the hedge fund industry? Is your due diligence up to the mark on these complex products?

Mr Baker: I suggest that you invite comments from the other practitioners, but to the extent that it is an issue it is a very small part of any problem. By and large, hedge funds did not deal in these highly exotic instruments. The risk management techniques of hedge fund managers by and large have come through this process in fairly good shape. The whole issue of asset-backed securities and very complex structures such as CDOs was largely avoided by the hedge fund community because of their sheer complexity. It was banks packaging and selling to other banks which seemed to be the biggest issue.

John Thurso: If that is a general view I do not need to pursue it.

Q281 Mr Mudie: I want to go back to one of the matters raised by the Chairman, namely the standards board and the failure to get your industry to adhere to it. The background to it was the G8 in 2007. It was so outraged by the behaviour of the hedge fund industry that it threatened legislation. I believe the German Minister of Finance called you "locusts". Your industry set up a working group and you now have a code of practice. That was 12 months ago. As you told the

Chairman, out of over 1,000 potential members you have attracted only 34. From where I sit that is a dangerous snub to the public and the authorities by your industry. Tell us what is happening.

Mr Marshall: In the next session you will have before you the chairman of the Hedge Fund Standards Board, so he will be able to give the best answer.

Q282 Mr Mudie: You are a person who has joined?

Mr Marshall: Yes.

Q283 Mr Mudie: But you were on the working group or were represented on it. Of the 34, 14 were the organisations who drew it up. Therefore, you have attracted 20 fresh members in a year. If I were a trade union official on recruitment I would be sacked.

Mr Marshall: It is small consolation but the 34 represent over 50% of the assets of the industry, so in terms of your concern about financial stability it goes quite a long way towards addressing that particular issue. Another way to interpret it is that the reason why the uptake has been so slow - the campaign for uptake started in the middle of last year - is that they are quite challenging standards. People have to go through a significant due diligence process internally - as the devisers of the standards and participants in it even we had to do it - before they are comfortable that they can sign up. That may well be the case for NewSmith.

Q284 Mr Mudie: I am not sure the insurance trade body ABI thought they were very high standards. As to the important aspect of disclosure it made recommendations which were turned down flat. A key part of the unhappiness with hedge funds is that they are not that high. As in the case of private equity, they are the bare minimum to stave off government regulation.

Mr Shaw: We stand up to the hedge fund standards. It is not right for everyone, but I think you should consider that in 2008 when people would have been doing their work to sign up to the hedge fund standards the business issues and challenges that the market posed to hedge funds were intense. We were worrying about where our clients' money was and our risk on banks.

Q285 Mr Mudie: Why did you sign up?

Mr Shaw: Because I felt that regardless of the standards our internal procedures and policies were very robust and the marginal degree of work by BlackRock in order to achieve the lofty demands was well worth it.

Q286 Mr Mudie: For a member of the public, an investor, even the FSA, who looks at the 34 organisations that have agreed to sign up to these standards the other 966 may be questionable.

Mr Zimmerman: They may have signed up to another standard that is more rigorous. In our case we have a hybrid business which is a combination of looking after pension funds and hedge funds. Because the bulk of our business is looking after pension funds - I do not want to get too technical here - we signed up for something called the audit and assurance faculty which is part of the Institute of Chartered Accountants. We think that the measures which they adopt are as rigorous as the Hedge Fund Standards Board.

Q287 Mr Mudie: Does it cost money to sign up to this standards board?

Mr Zimmerman: Yes.

Q288 Mr Mudie: How much would it cost you?

Mr Zimmerman: I cannot immediately answer that.

Q289 Mr Mudie: If you have higher standards because of your hybrid activities surely you can afford to sign up to this so you have the stamp of approval in both industries. Are you hard up or something?

Mr Zimmerman: It is not a question of financial concern but what is best for our business. At the time we decided to sign up for this particular control. As I said in my earlier submission - you make a fair point - we are looking at whether we should also sign up for the HFSB.

Q290 Mr Mudie: Mr Baker, do you not think there is a real danger that the authorities will feel you are challenging them to bring forward their own regulation?

Mr Baker: As a point of clarification, the figure that I quoted earlier for managers was somewhere between 400 and 450, so the number is not 1,000. It is managers who sign up to the standards, not their individual funds.

Q291 Mr Mudie: This is the trouble with hedge funds: we cannot get an exact figure for anything.

Mr Baker: It is partly to do with the definition of exactly what a hedge fund does. A lot of the standards have been employed by managers for quite a long period of time. There is a high degree of overlap between the large body of work that AIMA has been publishing for a number of years - we call them our sound practices - and the hedge fund standards. A lot of managers believe that they are already meeting the standards and therefore they are seriously considering whether or not to sign up. One thing we are very keen to do in our discussion with international regulators alongside the discussion about potential disclosure templates, disclosures and actions on short selling is to come up with a set of sensible measures which a supervisor can undertake when they come in to visit a manager. Rather than lifting up these standards and dropping them into statutory regulation, or formalising them within the regulatory code book, they could nevertheless become a very valuable checklist for the regulator to go through when they perform a supervisory visit.

Q292 Mr Mudie: Sir Andrew who chaired the working party must wonder why he put in all that time. As the Chairman says, your PR is pretty bad, is it not? You are threatened with G8 regulation and quite commendably you say you will try to protect self-regulation by having a code of standards. You work on that code for two years and you have 34 signed off. Do you not feel that the authorities will say that these lads are just not serious?

Mr Baker: I think it is very valuable that a lot of this stuff is now accepted practice and there is, therefore, a template for discussion. A lot of the regulators are referring to these standards as part of the debate. If all of it was to be lifted up and put into statutory regulation I do not think the industry would object. These are felt to be very commonsense standards.

Q293 Mr Mudie: Mr Hohn, why have you not signed up?

Mr Hohn: Our application is pending. We believe that we are largely compliant.

Q294 Mr Mudie: If you were an investment bank would the requirement to disclose to the authorities be higher or lower than it is now?

Mr Hohn: I think that disclosures on positions are the same as any investment bank.

Q295 Mr Mudie: Let me put it to you specifically. When we ask whether the hedge fund industry is regulated of course it is, but when you look at it closer the regulation is of the managers. Are you telling this Committee on the record that regulation of a total hedge fund is the same as the regulation of a manager? In other words, there are parts of the hedge fund industry that are not regulated and you simply regulate the manager. There are activities or corners that are not gone into because you are simply regulating the manager. I would welcome a straightforward answer.

Mr Hohn: Things like short selling disclosures are not captured.

Q296 Mr Mudie: No.

Mr Hohn: The answer is yes. I was just giving an example.

Q297 Mr Mudie: What are you saying "yes" to?

Mr Hohn: Yes, there are things that are not captured by disclosure.

Q298 John Mann: I was touched by hearing the problems that you are suffering but pleased that all of you have mentioned transparency. I am sure you will want to send us a note giving more details about your offshore finances but also perhaps you would include in that details of how much you have earned in the past three years so we can see the depth of the suffering. The submission of the Hedge Fund Standards Board says that there is no need for the protection of regulators and the market will weed out the mediocre. Let us take an example of one of the mediocre: Merrill Lynch. Why have you not been weeded out, Mr Shaw, because you were at Merrill Lynch, or even you, Mr Zimmerman, because you were there as well?

Mr Shaw: It is a market for labour and services and if we serve the investors in our funds well we will have a business. Like any other business if we do not do that we will be weeded out. We do not ask for protection, government money or taxpayers' money; we are not asking for special privileges. Our job is to serve our clients, help meet the objectives they set us and do that to the best of our ability. There is no special magic in that regard.

Q299 John Mann: If we look at the funds that get into problems the mediocre seem to re-emerge.

Mr Shaw: Funds do not go bust. They may lose money precipitously or unexpectedly; they may occasionally disappoint their customers, but they do not go bust.

Q300 John Mann: Where are the mediocre who have been weeded out?

Mr Shaw: As to the number of hedge funds as reported by various hedge fund databases, the peak was about 10,000 globally probably in the summer. That number may be 7,000 and potentially on its way to 6,000. Assets in the industry used to be reported at over \$2 trillion and are now \$1.3 trillion.

Q301 John Mann: But the managers re-emerge elsewhere with different hedge funds.

Mr Shaw: Only if their clients think they will give them a good service.

Q302 John Mann: Mr Hohn, three years ago Rolf Brewer of the German Stock Exchange stated that the activities of hedge funds were challenging stability and ripping the heart out of the economy. Was he not right?

Mr Hohn: I do not think so. One of the problems in the system is poor governance by the boards of companies. In the case of the banks, for example, the boards lacked oversight of management. In the case of Deutsche Börse we were exerting ownership rights as owners of the shares and naturally boards are resistant to that.

Q303 John Mann: But you exacerbate instability by definition?

Mr Hohn: I do not believe that is true. It is important that shareholders of companies are allowed to exercise their ownership rights. I think it is a very bad thing if there is no oversight of boards by shareholders as owners.

Q304 John Mann: Mr Hohn, in July when commenting on what he described as massive dislocation in the financial system Mr Marshall said that "it will create fantastic buying opportunities", so you do exacerbate such problems, do you not? That is your *raison d'être*?

Mr Hohn: I do not agree with that. You cannot just put everybody in the same bucket.

Q305 John Mann: So, was Mr Marshall wrong in saying that the massive dislocation in the financial system would create fantastic buying opportunities?

Mr Hohn: It has also hurt a lot of hedge funds. As Mr Marshall said, the average fund is down by 18% and many by much more than that. There are two sides to it. A lot of funds have been killed by it.

Q306 John Mann: When I go to the bookies there are always those who also lose regardless of how much they hedge my bets. There will always be losers, but there are "fantastic buying opportunities". Let me give you another example: the steel industry. Let us assume that the management decides to play the long game; in other words, to sacrifice short-term profits for their shareholders by keeping on employees and retraining them so they are well positioned to benefit from the projected outturn in two or three years' time. For hedge funds generally on the basis of that logic they would be a prime target, would they not?

Mr Zimmerman: I think that we are omitting the fact that there are many other investment vehicles around, long-only funds and mutual funds, that sell shares.

Q307 John Mann: But Mr Hohn was accused of that in relation to Deutsche Börse. The same logic - I do not suggest that it is his fund - of picking on a firm that is playing for the medium term, some would argue rationally in this case, that is, by sacrificing shareholder dividends and keeping on labour to benefit the outturn, would be a prime target for you to latch onto, would it not?

Mr Hohn: But we have never invested against intelligent long-term investments. We would support that.

Q308 John Mann: But a fundamental problem is that when things are on the up in the global economy it will balance out in some way or other, but when things are on the down the rational decision-making can be undermined by the whole mindset that is behind your industry?

Mr Shaw: Sometimes when things are on the down, as you say, it is the hedge funds that are buying. We should not forget that in the banking industry some of the largest shareholders who were buying into Northern Rock, which unfortunately went into national ownership, were hedge funds. Therefore, hedge funds are extremely diverse; they do not act in uniform ways and have differing opinions about where value is.

Q309 John Mann: Would you like to reassess your statement about the "fantastic buying opportunities", or have you secured them because they will come within three weeks, three months or a year but not longer?

Mr Marshall: My time is running out. I guess that that statement is an example of bad PR if you take it out of context.

Q310 John Mann: Would you like to apologise for it?

Mr Marshall: The people to whom I made those remarks were an audience of investors.

Q311 John Mann: But lots of people are losing their jobs. Small businesses cannot get loans. Would you like to apologise for that?

Mr Marshall: I think people will welcome the fact that we are looking to invest in businesses.

Q312 John Mann: Mr Baker, you said on 10 March 2008 that a serious threat to the UK economy as a whole was taxation of non-doms. On which side of the looking glass were you when you said that? Is not offshoring now part of the problem rather than the solution?

Mr Baker: My reply is that our industry is a huge success. Financial services are a very important part of the UK economy and the hedge fund industry within financial services is a great success story. Part of that success is built on the fact that it can thrive only if it attracts the very best talent around the world. A lot of that talent is international. If a regime is introduced - at the time I was talking about the introduction of the non-dom levy - there is a fear that given our industry is disproportionately dependent upon foreign professionals working in this country it would drive that industry away. We were not seeking special treatment; it was merely to say that we should keep in place a highly successful industry that depends on open borders and a level playing field when it come to the tax structure.

Q313 Mr Brady: Mr Shaw, you said earlier that hedge funds provided a way of reducing risk for investors. How do you explain the paradox that there seems to have been a loss of confidence in hedge funds and such big redemptions at a time of very high risk in other places for investors?

Mr Shaw: Hedge funds have enormous investment flexibility with which to measure and manage risk, but they have been beset by a number of challenges: the credit issue, who their counterparties are and what risks they are taking upon those. They were successful in taking risk off the table and reducing leverage overall in this banking crisis; they were reducing their short positions in UK banks going into this financial crisis and the ban. The industry has been beset by a number of challenges as have investors in the industry who in many instances have required liquidity. Sometimes hedge funds regardless of whether they have made or lost money are easier to get out of than other investments they have made. There has been something of a trend of hedge fund investors selling hedge funds because they need liquid assets for other purposes.

Q314 Mr Brady: You have just been severely beaten by my colleague. I want to give you the opportunity to come out fighting. Would you make the case that this is a time when given the risk in the markets people ought to be looking at hedge funds?

Mr Shaw: Hedge funds are very much counter-cyclical but they are very nimble; they can move their assets around rapidly and have more investment flexibility. As we sit here today I am sure that some people are carefully reviewing the position in UK banks. You saw a spectacular increase in Barclays' shares yesterday following the release of a statement at the expense of many short investors in that stock. Maybe people will now reappraise UK banking stocks as a marvellous opportunity.

Q315 Mr Brady: But at the moment you are all saying that redemptions are advancing[?]?

Mr Marshall: Yes. If I may add to that, possibly we are reaching a point where hedge funds will begin to enter the main stream. If you look at the investors in hedge funds, up to 70% of them are now institutional investors - pension funds, insurance companies and so on. We have also seen the UCITS framework which effectively allows funds to use leverage and manage according to value at risk. You now have a fund framework which will allow certain hedge funds - the less complex ones - to be sold to the retail market. I think that in future hedge funds will increasingly become part of mainstream fund management in people's understanding.

Q316 Mr Brady: If the position of pension funds amongst your investors increases in scale does it not argue strongly for a far higher level of regulation, which I suppose takes us back to Mr Zimmerman's earlier point about the other regulatory structures that are available for funds operating in the pension industry? Should you all be going to that regulatory model instead of the new one set up just a year ago?

Mr Marshall: As fund managers we are regulated like any other in the UK. I believe that the pension fund investment in hedge funds will come primarily through onshore vehicles or managed accounts rather than offshore vehicles. I do not believe that that will change the regulatory debate.

Q317 Mr Brady: Is that a common position? Mr Zimmerman, you made the point that you were already very heavily involved in pension funds and therefore had a higher regulatory standard.

Mr Zimmerman: Yes. One must not underestimate the amount of due diligence that is done by pension funds and other counterparties on hedge funds generally. It is very high. I grew up in the traditional fund management business and started in this area only in 2003/4. One thing I found was that the level of questioning and due diligence was very high.

Mr Shaw: Regulation is a two-sided coin. There is a crisis in the UK banking sector, but it is very highly regulated. London-based hedge fund managers are highly regulated. The funds we manage, especially those offshore, are very lightly regulated, but it is the highly regulated entities that are the cause of the issue, not the lightly regulated ones.

Q318 Mr Brady: To move to a rather different point, it has been suggested that a lot of hedge funds now hold quite large amounts of cash because they have no other place to put it. To what extent do you think hedge funds could fill the gap that is being left at the moment by the banks that refuse to lend?

Mr Baker: You have to look at the amount of lending that may be required. By and large, hedge funds do not engage in the sort of lending that we have been reading about as a requirement to kick-

start the economy. Hedge funds are a source of risk capital. If all the hedge funds were liquidated today one would have about \$1 trillion available for investment. With their global remits that would be spread across a very wide range of markets. Therefore, looking to hedge funds to solve the particular issues in the UK economy is probably a stretch too far.

Mr Shaw: There is an increasing amount of interest by investors in bonds which are securitised loans. Therefore, there is some interest in the high yields currently available in the marketplace.

Q319 Mr Brady: How much of the success of hedge funds and their managers in the past has been based on leverage? How important is leverage to what you do?

Mr Marshall: That is a very good question. I am not aware of a study which seeks to break down the different components of returns on hedge funds. Undoubtedly, some part of the return was based on leverage and some on what we call alpha, ie the skill component. Because it is a Darwinian industry the 40% or 50% of the funds that will disappear will be those whose returns are heavily dependent on leverage and it is owed to investors that they should get their returns primarily from alpha, that is, skill-based investing.

Mr Baker: Leverage has come down progressively.

Q320 Chairman: Mr Marshall, did you say that hedge funds would go into the retail market?

Mr Marshall: Not exactly. Hedge fund-like strategies are now being made possible through the UCITS framework to a limited degree; in other words, you can use a limited amount of leverage through things like 130/30 funds and if you are subject to volatility you can have a volatility framework where you can operate with leverage.

Q321 Chairman: The reason I ask that is that there is a high degree of disclosure in that market and it treats customers fairly. That is a big, big step.

Mr Marshall: Personally, I am very much in favour of it because in the world it is uniquely a framework where leverage limits are imposed.

Q322 Chairman: So, you are in favour of a massive step change in disclosure if that takes place?

Mr Marshall: Yes.

Q323 Jim Cousins: We have heard that there are 1,000 UK funds, not managers?

Mr Baker: That would be my guess.

Q324 Jim Cousins: How many of those funds do you think are closed in the sense that investors are being told they cannot get their money out?

Mr Baker: The imposition of gates?

Q325 Jim Cousins: Yes.

Mr Baker: There is no precise information. I have seen estimates that up to 30% or 40% of funds have had to impose gates, but let us not forget that a gate is very clearly disclosed in any fund's documentation. A gate cannot be imposed if there is not permission to do so within the fund's

byelaws. It is the directors of the fund, not the manager, who make the decision about whether or not a gate needs to be applied.

Q326 Jim Cousins: I understand that, but I think we both agree it is of some significance that gates, as you put it, may exist on 30% to 40% of funds. Reference has already been made to the locations of funds offshore for tax purposes. How many of the 1,000 funds do you think are offshore for tax purposes?

Mr Baker: I suspect that 100% of the funds are offshore. When we talk about "tax purposes" again we come back to my point about this being a global industry. Most funds attract investors from a variety of different countries. The funds need to be in a form which creates neutrality for all investors going into that fund. If there are elements of double taxation investors will not touch it. The reason that UK funds are by and large onshore is to prevent non-UK investors being exposed to the UK tax regime.

Mr Shaw: The funds are generally offshore but the assets of the funds, the bank accounts themselves, typically will be within the European Union or America.

Q327 Jim Cousins: If the funds are offshore what implications does that have for investor protection? We have already discovered a gaping hole in our system. People who have offshored investments find that they are not protected as investors. Is that an issue for hedge fund investors?

Mr Baker: An investor who wants to invoke his rights in terms of investor protection is obliged to do it through the jurisdiction in which the fund is centred, so a large chunk of the hedge funds managed in this country is based in the Cayman Islands. The Cayman Islands has a regulatory structure very similar to this country's. The FSA applies some degree of oversight because it wants managers to behave responsibly and to treat their customers fairly, but it cannot influence what happens to the funds in an offshore jurisdiction in terms of direct investor protection.

Q328 Jim Cousins: Mr Baker, you see where this has got us? Almost all the funds are offshored and 30% to 40% of them are gated and their investors must rely upon the investor protection systems in offshore jurisdictions. Is that something with which you are comfortable?

Mr Baker: The directors of any fund will realise that gating is a measure of last resort. The purpose of imposing a gate is not to hold onto the assets or cause discomfort. The only reason for imposing a gate is that it has become very difficult to treat leaving investors fairly with the interests of those investors who choose to remain within a fund. Today we have concentrated on a lot of strategies that are accused of being short term and speculative, but a large chunk of hedge funds invest long term in highly illiquid assets. If there is a sudden flock of redemptions no financial institution can withstand a significant run on its investor base.

Q329 Jim Cousins: As we are discovering.

Mr Baker: Last week Lord Turner used the phrase "contractual maturity transformation". Hedge funds do not have contractual maturity transformation; they are governed by their byelaws and the gates are a very specific liquidity management mechanism, but no manager would wish the directors of a fund to impose a gate because potentially it threatens its business. Holding onto investors' money is an absolute last resort; no one wants to do it. A number of people on this panel who have the facility to impose those gates have chosen not to even though it has led to severe redemptions from their businesses.

Q330 Jim Cousins: I should like to think about the implications of all of that. Perhaps I may ask the four practitioners the following question. Time does not allow us to go through this verbally. As far as your hedge fund operations are concerned - I narrow it down to that - could you supply the Committee with some information about how the pay structures work? I am not asking what the pay levels are but how it is structured. What are the reward systems that trigger whatever pay people end up with? If you could write to the Committee about that it would be more helpful given the time we have. Mr Hohn, you have been engaged in an effort to use hedge funds to improve corporate governance as you see it. That is right, is it not?

Mr Hohn: As part of their investments.

Q331 Jim Cousins: I am not trying to be horrible here, but you even in your own eyes you failed, did you not?

Mr Hohn: In what way?

Q332 Jim Cousins: In improving corporate governance. You have admitted failure in some of your statements. You feel rather frustrated that you were not able to use your hedge fund operations to improve corporate governance?

Mr Hohn: In some cases yes and in some cases no.

Q333 Jim Cousins: Would ABN AMRO be one of those cases?

Mr Hohn: Yes. I think ABN AMRO had a corporate governance problem. We thought that the wild acquisition spree was value destructive. What happened was that we put a motion on their AGM requesting the potential sale of the company and in a democratic process, not driven by hedge funds, over 70% of the shareholders in that giant company voted for that. They sensed that the board had failed the shareholders. In that example the shareholders did very well.

Q334 Jim Cousins: Mr Hohn ABN AMRO has landed up with the British taxpayer. Pray for us.

Mr Baker: Would it help to mention that last year the OECD wrote a report which looked at the impact of hedge funds and private equity on corporate governance? I am very happy to send you a copy of that.

Q335 Ms Keeble: You have talked about regulation and rules concerning the establishment of funds and the general principles and disclosure regimes. What you have not said - it came up frequently with the bank regulation - is how active the relationship with the FSA is and how often it contacts you, the nature of the scrutiny and the follow-up. Can you say how on a day-to-day basis the relationship with the FSA as regulator works?

Mr Baker: Perhaps I may describe just the general structure and the experience will be different for each firm.

Q336 Chairman: We went into the question of the FSA earlier. If you would write further to us on that it would be helpful. Have you shown what economic value you add, except to your investors? Apart from making money for people what do you do?

Mr Baker: We believe we employ about 40,000 people in this country. It is very hard to get hold of the tax figures but it is a significant employer. Apart from the benefits to marketplaces, it is a

counter-cyclical source of capital and the buyer of illiquid assets at the margin and therefore there is efficient price discovery. It supplies liquidity when other buyers are not available. Those are very esoteric but technical issues that operate within markets. The benefit is fundamentally to investors.

Q337 Chairman: Are there any big stories about what you do as practitioners that you want to give us?

Mr Marshall: We are part of the savings industry which is a very significant industry worldwide but which generally around the world has not done a great job. We will do well or badly depending on whether we deliver stable and dependable returns to savers. That is ultimately our purpose.

Q338 Chairman: Thank you, Mr Marshall; you have been very open. To sum up what I feel has come out this morning: first, in answer to Mr Mudie's question you have less disclosure than the banks; second, large hedge funds are possibly destabilising banks by short selling, as I think emerged from Mr Fallon's questions; third, I think you all agreed there was a need to ban naked short selling; fourth, you felt that there was a weak industry body and there is quite a long way to go there; and, fifth, as to disclosure, which was raised earlier and Ms Keeble has just picked up, you are waiting for the FSA to ask you for information. The question should be: why have you not thought of what you can tell them and engage more closely in that disclosure? Lastly, you have a poor public image and you have a long way to go. Is that a fair assessment, Mr Marshall?

Mr Marshall: I did not agree with all of the summary. You said that we were a weak industry body. The industry body is AIMA. I think you were referring to the standards boards.

Q339 Chairman: Yes, the Hedge Fund Standards Board.

Mr Marshall: The standards board has a slow uptake of its standards.

Q340 Chairman: Is it right that it is just like the private equity industry until it gets a rocket up it?

Mr Marshall: Frankly, I welcome this meeting because no doubt it will help to accelerate the process of signing up to the standards.

Chairman: You agree with that summation. Thank you very much. It has been very helpful to us and will feed in very well to our banking crisis inquiry.

Memoranda submitted by the Investment Management Association, the Association of British Insurers and the Hedge Funds Standards Board

Examination of Witnesses

Witnesses: Mr Peter Chambers, CEO, Legal & General Investment Management, Mr Richard Saunders, Chief Executive, Investment Management Association, Mr Peter Montagnon, Director of Investment Affairs, Association of British Insurers, Mr Alan Grisay, Chief Executive, F&C Investments, Mr Antonio Borges, Chairman, Hedge Fund Standards Board, and Mr David Pitt-Watson, Senior Adviser, Hermes Equity Ownership, Hermes, gave evidence.

Q341 Chairman: Welcome to the second part of today's session. Please introduce yourselves for the record.

Mr Chambers: I am Peter Chambers, chief executive of Legal & General Investment Management. We are 100% owned by Legal & General Plc, the insurance firm.

Mr Grisay: I am Alan Grisay, chief executive officer of F&C Asset Management which is a company listed on the London Stock Exchange.

Mr Saunders: My name is Dick Saunders, chief executive of the Investment Management Association.

Mr Montagnon: I am Peter Montagnon, director of investment affairs, Association of British Insurers.

Mr Borges: I am Daniel Borges, chairman of the Hedge Fund Standards Board.

Mr Pitt-Watson: I am David Pitt-Watson, a senior adviser to Hermes Pension Fund Management which is a fund manager and pension fund.

Q342 Chairman: Mr Pitt-Watson, do you have any sympathy for shareholders who have lost out or feel that their rights have been trampled on as a result of the part-nationalisation of a number of the UK retail banks?

Mr Pitt-Watson: I feel sorry for the ultimate shareholders in the damage that has been done generally in the recession because they are pensioners and ordinary people like you and me. I represent people in the British Telecom pension scheme. However, we are where we are with the nationalisation and the question that the shareholders and their agents need to ask themselves is whether they were partly responsible for where we have reached. I note that yesterday the chair of the ABI wrote in the Financial Times that there was a gap and they were not carrying out their duties as good owners in making sure the banks were behaving in an appropriate fashion. I think there is a gap despite the fact that this Committee and others in the past have sought voluntary codes of agreement to make sure that that governance would be carried out. Therefore, I have great sympathy for the people whose pensions have been lost; I have a bit less sympathy for the people who are in my industry.

Q343 Chairman: The question to be asked is: where were Mr Montagnon and his crew? Were they posted missing in terms of ensuring there was good shareholder value? For example, two years ago the Royal Bank of Scotland's price per share was 589p; yesterday it closed at 15p. What is the state of shareholder activism in this country?

Mr Pitt-Watson: I have lots of praise for Mr Montagnon and what he does at the ABI, but we are still probing the surface and in relation to the sorts of problems at the banks shareholders were not blowing the whistle. I welcome the fact that the chair of Mr Montagnon's committee is telling the Financial Times that we did not do this, that it is a problem and we should be looking for solutions.

Q344 Chairman: Mr Borges, you nodded when I asked the question.

Mr Borges: Chairman, you are absolutely right. We have learned a great deal in the past few months. One of them is that corporate governance in financial institutions has singularly failed. The

responsibility of boards was not properly carried out in many ways; risk was not properly controlled. If anything we need more, not less, investor activism.

Q345 Chairman: Mr Montagnon, with apologies to you, but this is not personalised - you are a good friend to me and this Committee - what about shareholder activism? Come on, let us get going.

Mr Montagnon: I think it is absolutely clear - we have said it - that we have not been as effective as we might have been. This is not because there was no activity; there was a lot, some behind the scenes, but it was not as effective as it might have been. We need to look at that and make ourselves more effective and we intend to do that, but we also need to put this in context. Just because we were not as effective as we might have been does not mean that we caused the crisis or could have prevented it, but it is right that we are players here and we have to improve our game.

Q346 Mr Fallon: Mr Borges, to return to the issue of the extent to which large hedge funds may pose a systemic risk, in your submission you say that currently the standards board is looking into behavioural standards. Therefore, there is a problem, is there not?

Mr Borges: No. We are reducing risk in the process of creating standards that will make this industry more reassuring so investors can have more confidence in it. Therefore, we are trying to look at every type of behaviour that will lead to this goal. We do not want to react after crises happen but take preventive action if possible. Most of those measures are designed precisely to engage with regulators, to create a scale of action that will evolve as problems become more serious and, therefore, to adjust to the severity of the circumstances.

Q347 Mr Fallon: But you say that a run on hedge funds can cause large-scale forced selling in the markets and concerns arise if there are perverse incentives to redeem early or in excess of what people want to redeem, forcing hedge funds to be more liquid than they should have been.

Mr Borges: Precisely. One of the issues we are now researching and on which we are in intense discussions with the FSA is precisely the best regimes for redemptions. We do not want a run of hedge funds; we want to protect every investor in hedge funds. We do not want investors who redeem early to be privileged. Therefore, we are trying to put in place standards that will deal with this threat.

Q348 Mr Fallon: But if you want to improve behavioural standards those standards must have been wanting in the past and presumably there has been some malign activity in the markets?

Mr Borges: No. It is true that what has happened over the past few months has taken many of us by surprise. Three or four months ago nobody would have expected Madoff to have happened. That also forces us to make our standards even tougher in the sense that we do not want crises like these ever to happen again if we can prevent them. In the same way, when the redemption regimes were put in place nobody expected the kind of massive redemption that has been taking place. Because that creates a threat to the model on which the industry operates we want to discuss how to deal with it.

Q349 Nick Ainger: Mr Borges, a senior consultant to your organisation, Thomas Deinet, said in September that signatories were rolling in and the total number of hedge funds committed to the standards would be announced in September prior to the first HFSB conference on 15 October. In the previous evidence session we heard that the number of hedge funds to sign up now totals 34 out of over 1,000. Would you describe that as a success? What is your definition of "rolling in"?

Mr Borges: First, let me clarify that Thomas Deinet is executive director of the Hedge Fund Standards Board, so he is very much in charge of this process. Both he and I were nominated in July. In the period up until July the standards were defined through a broad process of consultation which took a great deal of time with a deep study of the legal implications of the whole exercise, and it was in July that we began to unfold the effort to get signatories. Our goal was to get about 10 funds per month. That process started very well; funds started to join according to what was expected, and I would call that an early success. The process slowed down quite a bit after the crisis became extremely serious, because at this point many fund managers are telling us they are quite interested in it but they need to take time; it is a serious process that involves resources. At the moment they are so concerned with survival that they have to postpone everything else. But we have been getting between five and 10 every month which is what we wanted when the process started.

Q350 Nick Ainger: But 14 of those 34 were already on the working group, so presumably all of those were virtually automatically signed up. Since your involvement we have had 20 sign up. Is it not an indication that the industry does not want to participate in the standards board? Bearing in mind the bigger picture and it is now acknowledged by all parts of the financial services sector that we need better and, in certain areas, more regulation, the hedge fund industry appears to be flying in the face of the move towards greater regulation?

Mr Borges: I do not think so. We have already contacted about 120 fund managers. I point out that of the 400 fund managers based in London there is a core that represents the vast majority of the industry. A very significant number of fund managers are fairly recent; others will disappear rather quickly. This is an industry that evolves quite fast, which is one of its great attributes. If people do not perform well they disappear quite rapidly. New funds and managers emerge with the idea that they can be better and innovate. In that sense it is an industry that meets investors' demands and survives according to their success and performance. We have focused on the core, that is, the more stable funds that have been in operation for a while and represent the long term, whilst we also try to attract as far as possible the smaller funds. Of the core, I argue that until now only five have told us they are not interested. Some of them have told us they are not interested because they think our standards are not tough enough for them, whatever that may mean. Everybody else has said they are interested but they want more time. This is a lengthy process that consumes resources to be in compliance and this is not really the right moment to make big investments.

Q351 Nick Ainger: But if in a period where everyone is focusing on standards and regulatory compliance you cannot persuade the hedge fund industry as a whole to commit to what is in effect self-regulation do you not accept that you have completely failed in your concept of self-regulation and standards within the industry?

Mr Borges: I make two points. First, I do not think we have any problems in persuading people that this is important. Only a very small number of fund managers have said they are not interested; everybody else is, and I assume they will join shortly. I do not underestimate the time and effort required to join because the standards are quite onerous and complying with them is a serious responsibility. Second, this is not self-regulation but building on FSA principles. We have received a great deal of support from the FSA which believes they are an extremely helpful way to deal with the problems of the industry precisely because we are rooted in FSA principles; we extend FSA regulation in a way that makes verification by investors easier, which is our whole point.

Q352 Nick Ainger: Let us move on to the standards. The HFSB operates on a comply or explain basis. How do you respond to those who say that essentially it is toothless? It appears that some of the hedge funds have told you that already and that is the reason they have not joined up. If it is

deemed to be toothless firms are basically able to carry on as before. At what point do you start to take any action?

Mr Borges: First, I think it has been made clear by the previous session that one of the great advantages of London as a financial centre is the quality of its regulation. I would argue that one of the important components of that is the comply or explain principle which is admired by many investors who think this is exactly the way to go. That is a distinctive feature of our approach and one that we very much hope to maintain. It is not toothless at all because the whole point of our approach is that investors are in charge. Our role is to make that channel more effective and give more power to investors to control what is happening in the hedge fund industry. That is the whole purpose of the standards. In that sense we believe this is far more effective and powerful than other forms of regulation which perhaps are very prescriptive but do not operate. The current crisis shows that the regulation of the banking sector, however prescriptive it may be, has failed and it is appropriate to consider whether comply or explain and investor due diligence is a more powerful mechanism to achieve the results we want.

Q353 Nick Ainger: Of the 34 hedge funds that have now accepted the standards how do you monitor those and what sanctions are there if firms are found not to be complying?

Mr Borges: The whole point of our approach is that they are monitored by the investors. The standards are supposed to provide investors with a guide by which they will be able to verify whether or not the standards are being applied. This is not an industry that operates on the basis of small investors. These large investors - pension funds, insurance companies and so forth - have a great deal of expertise which they can exercise in their due diligence process to find out whether or not these standards are being met. The point of our effort is to provide hedge fund managers with a set of standards which they announce to the world they will meet and that facilitates the investor due diligence process and raises the whole industry to a different level.

Q354 Nick Ainger: The due diligence which has been shown by major institutions, for example those caught up in the Madoff scandal, was not very good. What gives you confidence that these standards will be able to prevent a Madoff repeat? For example, everyone expected that major banks would have had the resources, both financial and personnel, to carry out due diligence. Clearly, they did not and Madoff is a very good example of that.

Mr Borges: Madoff is probably the best example of why we need something like our standards. If our standards existed in the US the Madoff fraud could not have happened, or it would have been extremely difficult to carry out. Madoff operated with complete integration of the whole activity from custody to brokerage to management to evaluation and administration. It was all under the control of one person and that made possible the kind of fabrication of statements and mis-information that went on and prevented due diligence from discovering any kinds of results. With our standards this would not have been possible; it would not have happened.

Q355 Ms Keeble: You said that you approached 120 hedge funds of which 34 agreed to join and the rest for different reasons did not. Have you kept a record of the firms and their responses and their approach towards you and regulation?

Mr Borges: Yes, because we are in constant contact with them. The only ones we are not talking to are the four or five who have said they are not interested. Every other one we talk to virtually every week to verify how much progress they are making and how soon they will be able to join.

Q356 Ms Keeble: Are you prepared to disclose that to the Committee so we know the attitude of the different hedge funds?

Mr Borges: I am certainly prepared to disclose the response we are getting from the hedge fund managers.

Q357 Ms Keeble: The 120?

Mr Borges: Not one by one; that would be a little difficult. I would have to verify my records. I do not always talk to them myself, but really there is nothing to hide.

Q358 Ms Keeble: Can we have the information so we know the different hedge funds that have been approached and their attitude?

Mr Borges: Very good.

Q359 Ms Keeble: Is that information routinely shared also with the FSA?

Mr Borges: The FSA has not asked this question. It follows our progress steadily. I remind the Committee that the FSA has explicitly supported our approach on several occasions including some very formal speeches by the chief executive.

Q360 Ms Keeble: In terms of your best practice standards, you said that it was down to the investors to monitor it, but do you not yourselves do some monitoring of how far they are complying with your standards?

Mr Borges: No, we cannot do that; we are not in the process of enforcing standards. We are a very tiny organisation whose main responsibility is to keep the standards up to date and induce managers to sign up.

Q361 Ms Keeble: Does the FSA do any monitoring of your standards and how far the hedge funds comply with them?

Mr Borges: FSA has indicated that for fund managers that adopt the standards they will certainly verify the extent to which they are being followed. It will be an important part of their supervision process.

Q362 Ms Keeble: Are the 34 that have signed up being actively monitored by the FSA?

Mr Borges: They are actively monitored by the FSA in any case.

Q363 Ms Keeble: On your standards?

Mr Borges: Exactly. With those standards the FSA now has an additional instrument to verify at what level they operate. If you allow me to quote the chief executive of the FSA, "FSA will take compliance with these standards into account when making supervisory judgments."

Q364 Ms Keeble: You have said in your memorandum to us that you stand ready to co-operate and identify areas where refinement and adaptation of current regulation may be needed. Can you identify those areas for the Committee?

Mr Borges: A very obvious one is fund administration where we recommend independent third-party administration. We may make that standard a little tougher in the context of the Madoff scandal. That is a very obvious example which is on the table right now. We may also recommend some behavioural changes when it comes to redemptions as discussed earlier. These standards are very much alive and we shall be adapting them to our experience.

Q365 Ms Keeble: So, it is just in those two, administration and redemption, where you would recommend specific regulation?

Mr Borges: We are recommending that our standards become more specific or concrete. However, our standards cannot be changed every day; there is a lengthy consultation process before we put anything in place. We do not change them every week; maybe we will be doing it once a year.

Q366 Ms Keeble: Maybe?

Mr Borges: Depending on what we experience in the markets and if new problems teach us new lessons.

Q367 Ms Keeble: You have also said that you are prepared to contribute to the discussions around global convergence. Obviously, international regulation around the financial services industry is particularly important. Can you say what your contribution to the discussion would be and what kind of regulation or tightening you might recommend?

Mr Borges: There are two levels. First, we contribute a great deal to European regulation. I am one of the members of the Committee of European Securities Regulators. There is a market participants panel of which I am a member and to which I try to contribute to the best of my ability.

Q368 Ms Keeble: It is very clear that there are lots of discussions, meetings and thought, but I want to know what are the specific contributions and recommendations.

Mr Borges: I am not sure I can give you a precise answer because it is constantly changing depending on the agenda. Currently, we have two main objectives: one is to promote more convergence because that will help the global industry; the other very important one is to promote the London approach to regulation, which is not even met in the United States - the regulation of hedge funds in the United States is way below our standards, which is why Madoff happened - and persuade the Europeans that that approach is far better for the whole of Europe than anything else they may come up with.

Q369 Ms Keeble: Both you and the hedge fund managers who were here previously talk about responsibility to the investor. Do you not accept that with the amount of money being moved around very quickly there is a major responsibility to the public because of the impact on the economy and that is what justifies our concerns about tighter regulation?

Mr Borges: I think we all operate on the assumption - certainly the hedge funds tend to do so - that the goal is to benefit the broad economy. How do we benefit the broad economy? We do so by having proper financial markets that operate with maximum stability but also maximum efficiency. Beyond that, I think the discussion becomes: how do we achieve that goal? Is it through more intense or prescriptive regulation or through the comply or explain and private sector initiative process? This is where the debate may arise. I argue that so far we have shown that our approach is probably superior.

Q370 John Mann: Mr Saunders, in your submission you make reference to investors not bothering because they are over-reliant on credit rating agencies. Is that because they are lazy or thick and cannot understand the complexity of what they are buying, or is it a lack of transparency?

Mr Saunders: In some parts of the market there is an over-reliance on credit ratings. I think in particular of the sorts of mandates that pension funds give to managers which constrain them as to what they can invest in, say investment grade securities as designated by a credit rating agency. That is one reason why we were party to some guidance published before Christmas. That was prepared by the European Securities Forum and Asset Managers Association. That gave best practice guidance to fund managers. One of the matters to which we drew specific attention was that if one was given a mandate by a client to invest only in securities of a certain credit rating one should draw the client's attention to the risks inherent in that. Most major fixed income managers such as my two colleagues here have major inhouse research departments and would not rely on credit rating agencies at all but on their own due diligence and judgment.

Q371 John Mann: Would it help if some of these funds were brought onshore rather than offshore?

Mr Chambers: Most of the funds we manage are onshore, so from my perspective I do not think it makes much difference. Credit rating has three components. First, as Mr Saunders points out the mandates given to investment managers are generally determined by credit rating, so it is a standard thing; it is independent and it will be investment grade or better or worse. It is the same for placing money with banks. There is deemed to be an independent judgment that grade A1 or better is a suitable place to deposit money. It is an independent thing set by clients. Second, the credit rating agencies themselves got themselves horribly conflicted in two types of business. At the same time as they were rating banks and counterparties they also started to rate different parts of paper particularly in collateralised debt obligations (CDOs). Some of those tranches were in short and it with the test of time it seems that that did not fare very well. Part of the problem that exacerbated the bank issues early on in the process was the failure of some of these types of operations. There was a clear failing in credit ratings in that distinct sense. Third, do we rely on credit rating in terms of the only judgment to make when investing in a particular credit? No, we do not; we do our own work, but clearly it is a piece of information that is in the public domain and has some worth.

Q372 John Mann: Would you be more concerned if you were looking at an offshore rather than onshore fund?

Mr Chambers: I do not believe it makes an awful lot of difference. It depends on the offshoring. For example, if there is a UK gilt fund that is managed onshore as opposed to offshore there is no difference in the way the manager will manage; it is just a different regulatory background.

Q373 John Mann: Mr Saunders, are the regulators over-reliant on stories in the media to determine who they should be examining?

Mr Saunders: I cannot speak for the regulators.

Q374 John Mann: What is your opinion?

Mr Saunders: I do not think so. The media play an important role in putting information before the whole market. On the question whether the media should show self-restraint during periods of market instability or whatever, I do not think there is a case for special rules. One would have concern where market abuse is involved and somebody is using the media to try to move the market

in a particular direction, but the FSA has very strong powers to deal with market abuse and as far as I am aware those are sufficient to handle that situation.

Q375 John Mann: In your opinion is the FSA under-resourced, under-skilled or insufficiently empowered in terms of doing what you would want it to be doing?

Mr Saunders: We can take the Lehman collapse as an example. We would have liked the regulator to do more to step in to protect the interests of investors in that episode where something like 150,000 trades simply failed to go through when Lehman collapsed. We felt that the FSA could have put more resource and attention into the problems faced by investors.

Q376 John Mann: Is it a problem of their judgment or resources, skills or lack of power?

Mr Saunders: I think it is a bit of both.

Q377 John Mann: Not enough resources?

Mr Saunders: There are not enough resources.

Q378 John Mann: They could do with more resources?

Mr Saunders: And more of the correct resources. I do not think they fully grasped immediately the import of the situation.

Mr Pitt-Watson: When one thinks about regulation, what we have seen is a systemic crisis and a regulator that tends to be in its own wormhole. For example, there were big knock-on effects from the way we were preparing international accounting standards when thinking about the solvency of banks. If I was to criticise the FSA it would not be for their resources or skills but they needed to look out of their wormhole and recognise that the international accounting standards marking all these bonds to markets were hugely pro-cyclical and if anything went wrong suddenly there would be insolvent banks. We need to have someone who is overseeing the whole chain of regulation because right now it does not fit together.

Q379 John Mann: The Hedge Fund Standards Board has said that hedge funds rely on sophisticated investors who do not need the protection of regulators. These investors impose very high standards of performance on the industry and weed out the mediocre. Do you feel that the mediocre are being weeded out? Is that an accurate statement?

Mr Saunders: I think it is an accurate statement. Let us take the example of Madoff. The vast majority of the investment management industry steered well clear of Madoff.

Q380 John Mann: But everyone is saying that Madoff is a total exception and it could not happen here.

Mr Saunders: It is possible for a UK investor to invest in a US hedge fund, so it is a real issue. The option of investing in Madoff was open to all hedge fund managers in the UK.

Q381 John Mann: Can you give other examples of the mediocre that have been weeded out?

Mr Saunders: I cannot by name.

Q382 John Mann: Can anyone?

Mr Borges: I can. Even in the best years, for example the early part of 2007 or 2006, dozens of hedge fund managers closed down simply because their investors were abandoning them. This is the nature of the industry.

Q383 Chairman: In the Madoff scandal Santander lost £2 billion; HSBC lost £668 million and RBS lost £400 million, a total of £1.2 billion. Where was the due diligence of the banks, Mr Pitt-Watson?

Mr Pitt-Watson: As Mr Borges has said, I do not think it would be easy to pull off the Madoff scandal in the UK. It is extremely surprising that people who put in these sums of money did not note that there was no separate custodian holding on to the assets that Madoff held, that Madoff was audited by a firm of three auditors who were his old mates and that it involved £50 billion. This must raise questions.

Q384 Chairman: The point is that whilst it is said Madoff cannot happen in this country here we have banks who are losing money and it is the UK taxpayer who must pick up the bill for it.

Mr Pitt-Watson: Indeed.

Q385 Mr Mudie: You have said it could not happen. Mr Borges, when it did happen you were quoted as saying that the scandal highlighted just how important it was to have an independent process in relation to administration of the fund and its valuation. It also highlighted the need for robust governance practices and oversight and independent boards that challenged management procedures and behaviour. Those are your words, are they not?

Mr Borges: Yes.

Q386 Mr Mudie: You follow it by saying: "Hedge fund standards are designed to address exactly these issues." If the hedge fund standards are designed to deal with these issues what sort of commentary is that on the state of the hedge fund industry before your hedge fund standards are accepted throughout the industry? Are you saying to us that all these things are happening and, if so, how can you say to the Chairman that Madoff cannot happen here?

Mr Borges: The hedge fund standards are designed to become the norm and in that sense to make sure that every fund manager if possible adopts them and every investor knows when making his decisions whether a manager has or has not committed to those standards. Clearly, the standards are what they are because in Britain some of these best practices have been put in place over the years and we now have a much better tradition particularly on the issue of separation of functions and responsibilities and third-party involvement. This has evolved in Britain over the years precisely because there are principles-based regulations, comply or explain and respect for investors.

Q387 Mr Mudie: You cannot have it both ways. You bring forward standards and say, quite rightly, that they have been subject to consultation and have been accepted and you will adhere to them. Thirty-four members of the industry accept them. You cannot look an investor in the eye and say that the rest accept them because they have refused to sign up, or they have yet to sign up. The worrying thing that transfixes the Committee is the lack of transparency and the fact that you put money into something, are treated so offhandedly and you do not know what on earth is happening. There is really no process and no standards that are accepted throughout the industry. Clearly, we have a problem.

Mr Borges: I do not think so. You have to take into account that this is now developing. If in one year's time we still have 34 there will be good reason to worry. My conviction is that you do not need 100% acceptance. These standards will become the norm and the litmus test is when every investor-----

Q388 Mr Mudie: You cannot say that; that is of no comfort. Darwin said that we evolved, and look how long it took. Pension funds and individuals are losing money; we just cannot wait for the industry to evolve. You and your colleagues have quite rightly put some standards on the table. For some of us they may not be enough but at least it draws a line. You have two fingers up from the rest of the people in the industry. Where in the hell does that leave us? It leaves us as politicians with a problem but investors are also left with a problem. You have spelt out the problems in the industry and the industry has shown in turn that it is not willing to do anything about it. That leaves investors not knowing who they can and cannot trust.

Mr Borges: What will make the process accelerate a great deal is when investors demand the standards on the part of managers to be in place. I think the hedge fund industry has also evolved in a Darwinian sense and our standards are designed to accelerate that process rapidly. Our standards are designed to be imposed by investors, and as soon as investors make them a requirement you will see a sea change. We are in that process right now.

Q389 Mr Mudie: I am unconvinced. Mr Montagnon, your response to the hedge fund standards consultation document was very worrying; it was that there were a number of areas in the report which could have been given more explicit consideration or greater emphasis. These are to do with the quality of disclosure as to the investment objectives of funds, better reporting of the actual risks being run through leverage rather than generalised discussion of the risks that leverage poses and so on. My first and only look at the quote was late last night, but there was a reference in it to the effect that they had not accepted your consultation return which suggests that that is less than satisfactory.

Mr Montagnon: First, we applaud the hedge funds for putting these standards on the table. We believe that it is a move in the right direction and we want to support them in that because it is very helpful when an industry produces standards. It is true that when our members considered them it was felt that some of the elements to do with disclosure and transparency were not where they would like them to be, and we very much hope to be able to work with the Hedge Fund Standards Board to bring that up to speed. At the moment because in part we are not in that position I do not see investors being quite ready to do the monitoring role that the board would like them to do. When we are in that position I think the standards could be extremely useful, but I do not think that invalidates the effort so far; I just think we have a bit further to go and we are happy to go on that journey with them.

Q390 Mr Mudie: That is a very civilised and quiet answer. What you are saying is that your worries about disclosure and leverage have not been dealt with but, ever the optimist, you believe that you will evolve and deal with them some time in future. It is pretty worrying from an investor's point of view that your organisation raised these important points and they were not accepted in the final document.

Mr Montagnon: I would prefer to be quiet, civilised and optimistic because I believe that in discussion we can get it to move further in the direction we want.

Mr Mudie: You may be optimistic but that does not help an investor to take a decision when entering this opaque world.

Q391 Sir Peter Viggers: I should like to ask about the involvement of shareholders. Let us begin with Mr Chambers. I suppose I should declare an interest in that Legal & General manages the investments of a pension fund of which I am chairman. Has the recent turbulence in the markets revealed that shareholders and even assiduous investors who try to take an interest in companies' affairs are still pretty toothless in influencing those companies?

Mr Chambers: Our investors fall into two parts: those who vote with their feet and those who are engaged with corporations. Those who vote with their feet simply sell their shares; they do not like what they see and they go. In our case most of the money we manage is in index tracking funds, so we have to track index. If the stock is in the index we have it, so we are not able to vote with our feet for the bulk of our funds. It is very important to us that we do engage. The past 12 months have been a particularly sobering period for us in seeing whether or not our engagement has been efficient and effective. You can form your own judgment on that. I will give you a couple of numbers. During the course of the past 12 months we had 26 separate engagements with the senior directors of the major banks, so it is one every other week. I consider that to be quite a high level of engagement. It was relatively evenly spread through the year. In the first quarter we met with the chairman/chief executive - in some cases it was both and in some cases one or the other - of all the banks to ask about capital, because it was clear following the problems faced by Northern Rock that risk profiles were quite high and we could be comfortable with that only if there was sufficient capital in place. All of them to an individual said there was no need to raise other capital. Indeed, one of the major banks was very adamant. We asked them under what circumstances they would need more capital and the response was that there were no circumstances under which they would need it. That was six weeks before the rights issue. We then saw a number of banks straight after the rights issues, because, quite frankly, all of them had given an indication that they did not need this capital. In a number of cases, particularly the Royal Bank of Scotland, we suggested that the heads of the companies were no longer tenable and the chairmen and chief executives should both depart, though not at the same time because that would not be constructive. We gave that message to the chairman. We did not give him his own message; we spoke to the senior independent director. We also spoke to the chairman and the independent director twice on that subject. We were told that that message would get back to the board and we demanded action on it. We were then told that there would be action and we would be pleased by an announcement at the end of August. At the end of August they announced three new non-executive directors but said nothing about the chairman and chief executive. We engaged again and the only way in which the chairman and chief executive stood down at all was by the government requiring it as part of the capital-raising episode. The question is: did we engage enough? I would like to think we did. Why were we not listened to? I am not sure I can answer that question. Should we do more, and how can we do more effectively? I am not sure I know the answer to that but I shall be very happy to have a debate.

Q392 Sir Peter Viggers: Mr Grisay, how much resource do you devote to shareholder engagement?

Mr Grisay: This is an area where we are very proactive. We believe that we have to exercise shareholders' rights. We have about 15 people engaged full time in analysing what companies are doing and preparing our response to that. That is in addition to about 180 fund management professionals who take those views into consideration. I can confirm to you that we were very active last year, for example in the context of British banks. To give you an idea, in the course of the past 12 months we have had five meetings with the board of RBS, five meetings with some board members of Barclays and nine meetings with HSBC. Most of what we do is private engagement. We try to avoid making public statements with a view to destabilising the companies with which we engage. However, we are quite transparent about what we do. You can check on our website on a monthly basis those companies with which we have been engaging and exactly what

we have been doing with them. On an annual basis we publish a very comprehensive book, with which I am more than happy to provide you, that describes all the engagements we have had throughout the world with a number of companies and our activities. Looking at what has happened, could we have done more? Yes. In retrospect perhaps we should have been even more aggressive in engaging some of these companies and maybe voting.

Q393 Sir Peter Viggers: You have been active but perhaps there is a question mark over your effectiveness. Mr Montagnon, in your memorandum you have talked about the fragmentation of investments and said that some groups are less concerned. Whom do you have in mind?

Mr Montagnon: One of the features of the market in the run-up to the boom was that there was a much stronger presence of people whose interests were mainly trading rather than ownership. To some extent that diluted the ability of long-term owners to obtain the changes they might have been seeking from time to time.

Q394 John Thurso: I want to go back to the question of corporate governance. Before I do so perhaps I may draw attention to my entry in the Members' register of interests because I am a director of a plc and also chair its remuneration committee. Mr Saunders, do you concur with the comments of Lord Myners the implication of which is that the non-executives of the banks were culpably negligible in the way they behaved and in their failure to get a grip?

Mr Saunders: I would not endorse the words "culpably negligible", but non-executive directors along with all other parties - auditors, shareholders and so on - did play contributory parts in the crisis that has unfolded over the past year and a half. In relation to shareholders and non-executive directors, there is a hierarchy of information. As shareholders my colleagues would have no greater access to information than is available to the market as a whole. Obviously, the non-executive directors will see much more; they will see board papers and so on and will have greater access to the state of the company.

Q395 John Thurso: In a rights issue one of the things required is a going concern statement and that is something that is exercising all boards in this reporting year. There would have been one produced for the rights issues. It is very difficult to see how the comfort of the going concern statement matches the reality of what happened subsequently and quickly. Is that not a matter of concern? Are these non-executives capable of doing the work we believe we have asked them to do?

Mr Chambers: It is a difficult set of circumstances. The banking industry is a regulated one and we invest in it as such. There is a price to pay for that regulation. Therefore, one would expect that regulation to be at least reasonably effective. Of all outside people the regulators have the first line of sight in seeing what goes on in the banks. They have information that is not accessible by the rest of us as investors in the public domain. The other group of people who have line of sight are the banks themselves and their executive directors and above that the non-executive directors. One would have to conclude that the non-executive directors were not effective in controlling the activities of the executive directors; otherwise, we would not be where we are now.

Q396 John Thurso: Do you think that that is particularly so for big financial institutions and it is so complex that the part-time good old boy network cannot deliver people who are capable of making a judgment?

Mr Chambers: I think that is right. These companies are global and quite massive. A lot of the banks still have balance sheets in excess of £1 trillion. They are very substantial bodies with which

to get to grips. My view and that of my firm is that non-executive directors should be more involved and devote considerably more time to each non-executive position they hold. Therefore, they should be rewarded for it and, for want of a better expression, should be able to do a much deeper dive into companies, speak to people and review businesses further down to get a more all-round view. Therefore, they can act as representatives of shareholders and other stakeholders on a more effective basis than the way it has worked in the past. I would favour non-executive directors having fewer posts, spending much more time in each one, being much more involved, delving down much deeper and being appropriately rewarded for it.

Q397 John Thurso: I want to turn to remuneration structures. Much has been said about the fact that if you have a short-term remuneration structure you will encourage short-termism in activities. One of the submissions we have had, from memory that from the ABI, talks about the dangers of short-term investment and the fact that good investment is about going into a company and staying with it. Is there a need to have a thorough look at the whole way in which board level and senior executive remuneration, particularly in financial companies, is handled? Is the current regulation of remuneration committees just not up to the job?

Mr Montagnon: There is a distinction between the normal remuneration of executive directors in listed companies and what goes on in the banks. Because of the nature of banking and the cyclical fluctuation in revenues you will tend to get reliance on variable pay in banking. That will lead to risk to the business if it is not properly managed because people will seize the opportunity to get a bonus. We would say that this is not necessarily the job of a remuneration committee whose job it is to look at the remuneration of the board. It needs to be considered by the entire board in terms of its impact on the risks to the business. For that reason I think it would be useful if there was some reporting on it in the business review where the company talks about the general risk to the business. I think it would be helpful if the regulator looked into this.

Q398 John Thurso: What you are really saying is that the remuneration structure for the people below the board is a major risk to the business if it is not conducted properly?

Mr Montagnon: It may be.

Q399 John Thurso: It could distort the business and therefore the whole board ought to discuss it as part of the risk management process?

Mr Montagnon: Yes.

Mr Pitt-Watson: I should like to add one comment on the question of shareholder engagement. I am very impressed by what other fund managers round the table have done. If one is looking at shareholder engagement I am sure there has been a lot of it with banks in the past year, but a good deal of the things we are looking at was the build-up of the business model in those banks over many years. Whether or not we had the right people on the board, remember that we as fund managers approved everybody who was to go onto the board and also the remuneration schemes with the boards. We needed to do that before September 2007 when the Northern Rock crisis arose as well as post that period. I guess my question would be: how do you make sure that is happening so there is not a crisis rather than how is it that shareholders respond once it arises?

Q400 Chairman: What you are saying is that this has been a massive failure of corporate governance?

Mr Pitt-Watson: There has been a failure in corporate governance. I believe that if 18 months ago we had all scratched our heads about it people would have looked at a lot of the things we are looking at now and recognised there was a problem and perhaps something ought to be done about it. I suspect we did not do that because of some of the reasons that have been talked about, namely we are all very disparate and primarily a lot of us are trading shares rather than owning them.

Q401 Chairman: The Madoff case showed that there is relevance for it in the UK in that Madoff had three auditors. One was a long-term friend from college days and another was a relative, but investors in the UK did not do sufficient due diligence.

Mr Pitt-Watson: In terms of the funds into which they put their money clearly there is an issue.

Q402 Chairman: This morning has been very helpful. To sum up, investors are supposed to carry out due diligence and there is regulation by use of the Hedge Fund Standards Board but we still have a way to go with that. The recent crisis has shown how due diligence even by the most sophisticated investors can be a second order priority to getting a slice of the pie and that indicates a market failure by investors. It is too short term and therefore it needs a regulatory solution.

Mr Pitt-Watson: Is that a question to me?

Q403 Chairman: It is a summing up.

Mr Pitt-Watson: I am cautious about regulation.

Q404 Chairman: It needs a solution?

Mr Pitt-Watson: I think it needs a solution.

Q405 Chairman: What is the solution?

Mr Pitt-Watson: We need to get responsibility and accountability into the system and regulation is part of that. To me, one of the problems in this crisis is that everybody who was a market participant said, "As long as it is not regulated against I can do it." That will not work; what will work is that the regulation should provide some minimum but beyond that people behave responsibly and they are accountable for the way they behave and if they do the wrong thing it is made known.

Q406 Chairman: Maybe the regulator needs to ask more questions.

Mr Saunders: On the question of regulation, there is a good case in point if we go back to Madoff. There are a number of funds in Luxembourg which have very substantial exposure to Madoff and a good many retail investors in both France and Germany have lost a lot of money as a result. That is not the case in the UK. The exposure of the UK retail fund management industry is indirect and negligible. One of the reasons for it is that within the UK we have adopted a supra-equivalent piece of legislation to the UCITS directive which is the requirement that the depositary who oversees the fund manager is in a completely separate group from the fund manager himself. That is not a requirement in, say, Luxembourg where in one case UBS was both depositary and manager. That is a piece of supra-equivalent regulation which can protect investors.

Q407 Chairman: I am trying to sum it up so I can let you go.

Mr Montagnon: If we do need more regulation we need to look at what purpose it serves. Regulation would be helpful insofar as it creates a framework and incentives for operation of the sort of chain of accountability to which Mr Pitt-Watson referred.

Q408 Chairman: We agree that there was a market failure. Whatever the solution we have to find it. We could say that the politicians are the legislators. When a market failure has been identified I am just a wee bit anxious when I hear you say that we should not give you more regulation. There is an issue here.

Mr Borges: You are absolutely right to say there have been market failures in many segments of the financial system but not in hedge funds. The hedge fund approach is that those who fail bear the consequences. That is not market failure.

Chairman: We have identified market failure. Do not upset the applecart. Thank you very much.