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PAPER 2B: BUSINESS

For information only, not to be translated: The following leader from The Financial Times *in June 2005 deals with hedge fund regulation. Translate into your target language to appear on the business page of a quality daily newspaper.*

TRANSLATION TO BEGIN HERE:

A moving target

Watchdogs' stance on hedge funds needs to evolve

Hedge funds do not stand still. That is one of the few certainties in the uncertain world of hedge fund regulation. As Britain's Financial Services Authority acknowledged this week in two thoughtful discussion papers on the issue, the very definition of a hedge fund is in flux. The FSA's paper on the protection for retail investors does not even risk using the term in its title. "‘*Wider range*’ investment products" is its preferred description of those products that "exhibit high degrees of volatility, illiquidity or complexity and which appear in a variety of different forms and structures".

Despite these difficulties, however, regulators are duty-bound to keep the industry under scrutiny. The question is what sort of regulation impedes the operation and development of a healthy market and what sort encourages it.

There are two areas where regulatory intervention is relatively easy to justify. One is market abuse. The FSA issued a clear warning this week to hedge funds that it believes may be "testing the boundaries of insider trading and market manipulation". A second area is systemic risk. Again, regulators and central banks have made clear that they are trying to assess such a threat and will act if necessary. In this regard, the FSA's interviews with investment banks' prime brokerage departments - which serve the hedge funds - have already served to identify potential shortcomings in risk management.

Honest citizens expect the police to intervene in the event of an assault, let alone a full-fledged riot. But they expect a lighter touch when the complaint is mere boisterousness. The evidence so far is that regulators understand when to leave healthy market volatility to do its work - even if that means standing by when hedge funds that overreach themselves collapse. The victims, in such cases, are "sophisticated" investors - institutions, pension funds, endowments and wealthy individuals who should be qualified to assess risk and act accordingly.

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The bigger challenge is deciding whether and how to offer retail investors a chance to take these risks. Regulators' attitudes already vary and they will have to evolve to take account of such factors as new European legislation. Hedge funds are themselves changing. At the more conservative end of the spectrum, some funds appear to be closer to conventional asset managers. At the other end, many hedge fund managers probably have little desire to tailor their product for small investors. Their hefty fees alone would probably deter most retail clients. But some conventional fund managers do want to be able to use hedge fund strategies as they strive to achieve superior returns.

Restrictions, in short, may disadvantage retail investors rather than protect them.

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