

## Conference on East Asian Financial Markets – the Next Frontier The Challenges of Globalization on East Asian Financial Markets Martin Wheatley<sup>1</sup>, Chairman of the Securities and Futures Commission June 2006

Good morning, Chairman Kharas, Ladies and Gentlemen:

1. I am honoured to be invited to join today's High Level Panel on East Asian Financial Markets.
2. I have been asked to focus on the practical measures that need to be taken, at both the regional and national levels, to further develop the financial markets in the region. This is a timely discussion because only two weeks ago, the SFC hosted the 31st Annual IOSCO Conference in Hong Kong. For those of you who may not be familiar with IOSCO, it stands for the International Organization of Securities Commissions. It is the world's main forum for international cooperation among securities regulators, and the recognized international standard setter for securities markets.
3. This recent conference attracted over 650 delegates from more than 135 jurisdictions. One of the main areas of focus of the conference was the public panel discussions on various important regulatory issues. These included issues such as the implementation of the new International Financial Reporting Standards; the regulation of hedge funds; the transparency of bond markets and the experience of emerging markets in implementing IOSCO standards and the IOSCO MOU, more of that later. So you see, it is quite opportune that I should be sharing my thoughts with you today on measures for developing financial markets, in particular, the securities markets in the region.
4. I thought I'd start by first highlighting some of the challenges that securities markets face today, particularly in the light of increasing globalisation. Next, I will discuss how securities regulators are trying to deal with these challenges on an international level together with other international organisations (i.e. the World Bank and IMF). Finally, I will focus on issues relating to the regulation of hedge funds, as this has been a hot topic in the financial world in recent years given the prominent role they have played in the global financial market and is particularly relevant to Asian markets, given the experience of 1998 and the Asian Financial Crisis.
5. *So with that agenda, let me start first with the Challenges of Globalisation.*
6. It has been widely recognised that globalisation in trade and services has been a key contributor to the rapid economic growth in many Asian countries in recent times. Asia is increasingly becoming an important driving force in the global economy. Asian countries now account for about 25 percent of the global economy, in terms of both size and recent economic growth. Its share in global trade increased from 11 percent in 1960 to 26 percent in 2005. This has been a remarkable achievement.
7. However, globalisation also imposes its challenges and disciplines, in particular in the financial services sector. The growing integration of global capital markets has increased the risks from volatile international capital flows and financial contagion, and exposed weaknesses and vulnerabilities of local markets. To capitalise on the benefits of a globalised financial environment, it is important for Asian economies to take steps to address these pressing issues.

<sup>1</sup> The speech was presented to the High Level Panel on East Asian Financial Markets at the conference organised by the World Bank and the Hong Kong Monetary Authority on 22 June 2006.

8. *This brings me to my second point today which is how are securities regulators dealing with these challenges on an international level.*
9. Since the Asian financial crisis, we have gained a much better understanding of the problems facing the financial sector, and how to address them. As a securities regulator, we know that there is a need to set, and encourage compliance with, global standards in regulation, accounting, corporate governance, transparency, and other areas which are critical to the sustained and healthy growth of securities markets.
10. Within the securities industry, two initiatives in particular are helping to move us closer towards these goals.
- First, the standards for securities regulation advocated by IOSCO; and
  - secondly, the Financial Sector Assessment Programme (or FSAP for short) jointly sponsored by the World Bank and the International Monetary Fund (IMF).
11. I will elaborate on each of these in turn – starting first with the standards advocated by IOSCO.
12. As I mentioned at the outset, IOSCO is the world’s primary forum for international cooperation among securities regulators, and the recognized international standard setter for securities markets. Its members are from more than 100 countries and regulate more than 90% of the world’s securities markets.
13. In 1998, IOSCO adopted a comprehensive set of standards called the “Objectives and Principles of Securities Regulation” (or IOSCO Principles, for short). These set out a broad general framework for the regulation of securities markets.
- There are 30 principles in all – all fairly high level – and they are based on 3 objectives, namely protecting investors; ensuring fair, efficient and transparent markets; and reducing systemic risk.
14. The principles cover a range of important securities regulatory issues. In broad categories, these are :
- regulatory structure and governance,
  - self-regulatory organisations,
  - enforcement and cooperation,
  - the regulation of issuers, intermediaries, investment funds and secondary markets.
15. I will mention a few of these principles so you can have an idea of what they cover and how broad they are. So, for example:
- regulators must be operationally independent, accountable and have proper resources and adequate powers;
  - regulators should have authority to share both public and non-public information with domestic and foreign counterparts;
  - there should be full, timely and accurate disclosure of information that is material to investors’ decisions;
  - there should be initial and on-going capital and prudential requirements for intermediaries and these must reflect the risks they undertake;
  - trading, clearing and settlement systems should be subject to regulatory oversight; and
  - there should be proper management of large exposures, default risk and market disruption,
- and the list goes on. These principles are today recognized as the international regulatory benchmark for all securities markets.

16. As we know, it is not sufficient just to have the principles. More fundamentally, it is important for countries to implement these principles. In April 2005, IOSCO resolved as a priority to improve enforcement related cross-border cooperation and to fully implement IOSCO Principles. With regard to cooperation, IOSCO has also adopted a multilateral memorandum of understanding (what we call the MOU). This is designed to facilitate cross-border enforcement and exchange of information among the international community of securities regulators. The MOU was adopted in May 2002 and it represents one of the organization's most significant contributions in the area of regulatory cooperation and effective cross-border enforcement. There are currently 38 members who have signed the MOU, while an additional 9 members have expressed their commitment to seek legal authority to become a signatory that would enable them to provide enforcement-related cooperation and exchange of information under the MOU. IOSCO has set the deadline of 1 January 2010 for all IOSCO members to become signatories or to make a firm commitment. IOSCO stands ready to provide assistance to guide members through the application process.
17. At the Annual Conference of IOSCO earlier this month, IOSCO adopted a new resolution on asset freezing. This encourages members to examine the legal framework under which they operate and to enable the freezing of assets derived from cross-border securities and derivatives violations. In this way, those who break the laws of the securities sector will be unable to benefit from any gains made as a result of their illegal actions. This is an important next step in enforcement-related cooperation among securities regulators.
18. On assessing the implementation of IOSCO standards, besides the work being performed by IOSCO itself, there is other major initiative, FSAP – that is, the Financial Sector Assessment Programme.
19. FSAP is a voluntary programme that was jointly launched by the World Bank and IMF in May 1999 in the wake of the Asian financial crisis. It is designed to give participating countries a comprehensive assessment of their financial systems by providing an independent review of the strengths and weaknesses in their financial sectors, and proposing remedial measures to reduce vulnerabilities and improve the effective functioning of the financial system.
20. An FSAP assessment is based on internationally recognised standards and codes and allows participating countries to benchmark their regulatory and supervisory systems against them. Many of these standards have been developed by internationally standard-setting bodies including the Basel Committee on Banking Supervision, IOSCO, the International Association of Insurance Supervisors, the Committee on Payment and Settlements Systems, the International Accounting Standards Board, the Financial Action Taskforce and others. As you would expect, the IOSCO principles have been adopted as the standards for assessing securities markets.
21. *So that covers the international efforts at strengthening the soundness of securities market. As mentioned earlier, globalisation can also be a source of vulnerabilities and volatility. The recent sell off in the global stock and commodities markets provides a vivid reminder of such a risk. Of course, countries with a strong and sound financial system are in a much better position to absorb*

*and withstand external shocks. This brings us to the issue of the regulation of hedge funds which are playing an increasingly important role in the global financial market. What I'll try to do is to share with you the issues we face regarding hedge funds and how we are addressing these.*

22. Hedge funds have experienced rapid growth in recent years. Most of this growth has been in North America and Europe, but growth in Asia is also increasing.
  - In 2005, the estimated size of the hedge fund industry in the Asia Pacific region was at around US\$48 billion, up 50% from the US\$32 billion in 2004. And we expect to see even more growth this year.
  - In Hong Kong, based on market information available as at the end of March 2006, we had about 148 hedge funds operating with total assets under management of US\$17 billion (compared to less than US\$1 billion ten years ago in 1996).
23. In Hong Kong, the subject of hedge funds is a hot topic and has always attracted much media attention and coverage in local press with particular focus on how hedge funds would affect the stability of Hong Kong's financial market.
24. It is perhaps not surprising that the public and media should focus on concerns about market stability when looking at hedge funds. Like some other East Asian countries, Hong Kong too was a target of speculative attacks by hedge funds at the time of the Asian financial crisis. During the Asian Financial Crisis in 1998, Hong Kong became the target of hedge funds due to the dollar peg monetary system, our fully convertible currency, lack of foreign exchange control and transparent financial systems. These hedge funds successfully played off Hong Kong's linked exchange rate system against the stock and futures markets by holding very large short positions in the futures market. At the height of the crisis, the aggregate short position in stock index futures held by 4 hedge funds amounted to 49% of the total open interest in our market. These funds therefore had the potential to cause serious disruption to our market and loss of investor confidence.
25. However, what is perhaps often overlooked is that at the time of the Asian financial crisis, the hedge fund industry was dominated by a few large global macro hedge funds. Since the collapse of LTCM (Long Term Capital Management) in 1998, the hedge fund industry has undergone tremendous changes, and by the end of 2005 there were over 8,000 hedge funds of various sizes around the world managing assets worth over US\$1 trillion, and using different investment strategies.
26. While hedge funds have the potential to adversely affect financial stability, they also have the potential to contribute to the efficient functioning of the financial market.
  - First, they provide a major source of market liquidity. It is estimated that in New York and London about 40-50% of securities trading comes from hedge funds. In Hong Kong, based on rough market estimates, about 30% of the daily turnover on our stock market comes from hedge funds. In over-the-counter markets, by taking risks that would otherwise have remained on the balance sheets of other financial institutions, they add depth and breadth to capital markets and provide an important source of risk transfer and diversification.
  - Secondly, hedge funds are playing an increasing role in making capital markets more efficient. Through arbitrage activities and

willingness to deploy innovative investment strategies, they play a valuable role in reducing or eliminating mispricing and market anomalies.

- Thirdly, hedge funds offer an alternative investment choice for investors. The rapid growth of this industry is a testimony of the fact that there is a genuine demand for them.
27. However, one also needs to be mindful of the potential adverse impact which hedge funds could bring to the global capital markets given their enormous financial power amplified by the use of leverage and their more aggressive trading style.
  28. Hedge funds are here to stay and the industry is expected to grow further, especially in the Asian region. A record number of new hedge funds are setting up in Asia with around 79 new hedge funds launched in 2005. Hong Kong proved to be the most popular destination for new Asian hedge funds to set up their base, followed by Australia, Singapore and Japan.
  29. Regulators around the world have begun to adopt regulatory measures to address the risks that hedge funds can pose on the financial market.
  30. In the US, starting from February 2006, all hedge fund managers are required to be registered with the US Securities and Exchange Commission, unless exempted. In the UK, the FSA set up a centre of hedge fund expertise in October 2005 to increase its supervisory oversight of 25 of the largest hedge fund managers in the UK. The FSA also collaborates with the London Investment Bankers Association on the establishment of regular six-monthly surveys of the exposures to hedge funds of London based banks providing prime brokerage services.
  31. In Hong Kong, licensing requirements are imposed on hedge fund managers who operate here, regardless of whether the fund being managed is offered to the local public or to professional investors only. About 80 hedge fund managers and advisers are currently licensed by the SFC and they operate 148 hedge funds in Hong Kong.
  32. In addition to implementing these regulatory measures, we also believe it is important to maintain regular dialogues with the industry. The SFC maintains regular dialogue with the major prime brokers operating in Hong Kong. This will give us a better handle on the trading activities of hedge funds and help us better prepare for threats to market stability.
  33. On the international front, IOSCO has also been looking into issues relating to the regulation of hedge funds. In particular, it is exploring how hedge funds can ensure clear, concise and effective disclosure of their features particularly regarding fees, risks, experience of fund managers, internal controls, performance and conflicts of interest. In addition, given the importance of valuation and challenges presented by the assets and liabilities carried by hedge funds, IOSCO has also decided that a set of principles in terms of valuation and administration may prove of value to the hedge fund industry. The work of IOSCO in these areas is continuing.
  34. Another relevant and important initiative organised by the private sector is the work done by the Counterparty Risk Management Policy Group which was formed by a group of internationally active commercial and investment banks in January 1999 after the collapse of the LTCM. The Policy Group has issued two comprehensive reports, one in 1999 and the latest one in 2005, to promote strong and best practices in counterparty credit, market and operational risks management.

## Conclusion

35. In conclusion, global financial markets are facing challenges never faced before. With increasing globalisation and a changing economic and financial landscape, new issues will constantly arise testing our effectiveness as regulators. As the global network becomes more integrated and extends its coverage, implementing global best standards and practices and promoting regulatory cooperation becomes key to ensuring market integrity and investor confidence. As part of the global network, East Asian financial markets also have a role in taking these initiatives forward. We have already embarked on this course through the work of various international organisations. I believe that over time, we can have a global market that is fair, efficient and transparent to all.
36. Thank you. ■■