HKSI
Luncheon Speech by Mrs Alexa Lam
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Good afternoon. Thank you for inviting me to share some of my thoughts on a very current topic with all of you.

Introduction

When it comes to the issue of regulating hedge funds, there is bound to be enthusiastic debate. There are always questions about the risks hedge funds pose and whether they should be regulated and if so, how they should be regulated. Should hedge funds be offered to only private, high net worth, professional, institutional investors? Or should they be made available to retail investors?

There are no conclusive answers to these questions, as the market is always changing but I will touch on how we at the SFC approach the regulation of hedge funds in Hong Kong. Hopefully this will give you a better understanding of the issues involved.

Before we do that let's delve into some interesting real life case studies and see if there are any lessons we can learn from them. There's nothing like a big bang to start things off!

The devil and the deep blue sea

You may ask, "Are hedge funds really that dangerous?" According to a World Economic Forum (WEF) study, "surging oil prices, a pandemic or extreme weather are more likely to negatively impact the world's economic growth" than the collapse of a big hedge fund.

To put that sentiment to the test, Amaranth Advisors, a very large US hedge fund, imploded a few weeks ago and many expected its failure to shake financial markets around the world. Indeed, Amaranth's cash losses of about US$6 billion were significantly larger than the US$4 billion loss when LTCM collapsed in 1998.

An interesting fact of the melt down of Amaranth is that despite the size of the loss, it barely affected the financial markets. In the years post LTCM, many were dreading the collapse of another major hedge fund and the systemic impact that this would create and how it could reverberate through the world's financial markets. But this did not happen with Amaranth. Its collapse did not lead to any Armageddon in the financial markets around the world. In a matter of two weeks, the crisis was mostly over. As was noted in Fortune magazine, there were no emergency meetings by the US Federal Reserve or huge Wall Street institutions scrambling to devise a rescue package.

Proponents for less regulation of hedge funds could possibly hail this event as proof that the business is self healing. It has been reported that when Amaranth was melting down, bidding by other hedge funds for its loans and convertibles that were sold to cover its losses was so competitive that they were barely discounted.

One of the lessons learnt in the LTCM debacle is that the hedge fund managed to build huge levels of leverage because their major credit providers failed to be vigilant in their counterparty risk management.

Post LTCM, regulators have been calling on counterparties including banks, prime brokers and other liquidity providers, to put in place and implement rigorous risk management measures. Internationally active financial institutions have strengthened their due diligence regimes, and also their ability to measure potential risk exposures. The relative calm that followed the Amaranth implosion offers positive hope that hedge fund failures need not bring chaos. It also offers hope that counterparties and liquidity providers have diligently implemented their risk control measures.

Amaranth appears to be another classic case of a young, overconfident and aggressive trader who was allowed to make huge and highly geared bets from his home. And, while the world's financial markets did not go into a tailspin, investors in Amaranth are no doubt still nursing their wounds.

Amaranth, therefore, is a timely reminder of 3 areas of weakness in the system:

(i) Hedge funds have become significant revenue contributors to some investment banks. Under such a competitive environment, the prime brokers may be tempted to relax their risk management and credit policy for some of their larger hedge fund clients;

(ii) The lack of proper oversight by senior management in hedge funds is a recipe for disaster; and

(iii) Investors must carry out thorough due diligence, and demand more risk transparency from their hedge funds.

Two regulatory models

Let us now drill down to define some basic terminology. When regulators talk about hedge funds, we are referring to the entity or product that offers investment opportunity to investors. Separate from the entity or product are the hedge fund managers. These are the people who advise the hedge funds and give advice or make investment decisions according to the mandates set out in that hedge fund.

First, the product. There are currently two regulatory schools of thought. The predominant approach is that because hedge funds are considered risky and complex products, they should only be made available to private, institutional and professional investors. The US and the UK are examples of this model.

However, there are a few jurisdictions, including Hong Kong, that believe while the bulk of the hedge funds should be for private, institutional and professional investors, a segment of hedge funds can be made available to retail investors as long as certain stringent requirements are satisfied.

Retail hedge funds in Hong Kong

We feel that hedge funds are an exciting product and should not be altogether barred from the retail public. However, bearing in mind that retail investors may have less resources available to them to demand adequate risk transparency and structural safeguards, we have imposed stringent requirements on the structure, fund managers' competence, performance fees disclosure, etc.

The authorised hedge fund market is very small, with total AUM of authorized hedge funds amounting to only US$1.48 billion as at the end of June 2006. Although this is a very small section of the hedge fund industry in Hong Kong, we will not compromise on the high standards expected. If hedge funds wish to offer their units to the retail public, it is only fair that the fund product in question should adhere to the stringent authorisation requirements with respect to the authorisation of that product.

Private hedge funds

Private hedge funds constitute the majority of the hedge funds offered. They are not subject to the same stringent requirements as retail hedge funds. They do not need to be, as private hedge funds target professional institutional investors who should be savvy enough to do their own due diligence, assess the risks involved and monitor the performance of the funds. In addition, such investors should be able to withstand losses should a fund fail.

That said, all private hedge funds are still subject to the laws against fraud, insider dealing, market misconduct, general principles that they should treat their clients fairly and manage conflicts.

Our hedge fund survey

You may be interested to know that we recently carried out a survey on all our licensed hedge fund managers on the hedge funds that they manage or advise. We hope to publish the results soon. This should help the market and industry, as a whole, to see where it is going. According to the survey, the good news is Hong Kong has a large AUM, which has substantially increased from just two years ago.

Licensing of hedge fund managers

Let us now move on to the managers. While private hedge funds are not subject to authorisation, all hedge fund managers operating in Hong Kong, whether the funds they manage or give advice to are offered to the public, are required to be licensed. In this regard, there are no exemptions and no shortcuts. Based on our recent survey mentioned above, we noticed that a number of our licensed hedge fund managers are part of large hedge fund groups that are headquartered in Europe and the United States and we welcome them.

As a statutory gatekeeper, we are duty bound to perform our due diligence when these people come in for a licence. To do this properly, we need to understand the managers' investment strategies, internal controls, their expertise, substantial shareholders' as to their fitness and properness, and financial resources, etc. It is against this information that we can assess whether they have the appropriate risk management models and expertise to manage the market, trading, liquidity and counterparty risks. Our key concern is how they manage the different risks.

Ongoing supervision of licensed fund managers

Once the managers are licensed, they will be subject to our ongoing supervision. This means that they would be required to comply with our general code of conduct and also the code for fund managers.

Last year, our supervision staff carried out a round of theme inspections on a sample of hedge fund managers. We detected some problems such as insufficient segregation of oversight responsibilities and lack of checks and balances, conflicts of interest (e.g. side letters), problematic valuation for complex, illiquid and bespoke financial products, sub-standard offering documents, and backlogs in counterparties' back office operations. These issues are not just peculiar to Hong Kong. Overseas regulators of major financial markets and IOSCO are also looking at these issues.

Systemic risk

How do we address the issue of systemic risk? We do not pursue a zero failure regime. Hedge funds, like any other business, can fail. Our concern, however, is that failure of a large hedge fund or a group of hedge funds may have serious consequences on financial institutions with significant hedge fund exposures. In addition, the impact of these hedge fund failures can be transmitted across the broader financial markets in the form of sharp price fluctuations and market turmoil. These failures can undermine financial stability.

The systemic risk may arise from a combination of factors:
- Multiple layers of leverage;
- Multiple sources of exposure of credit providers;
- Market dynamics amplifying price movements;
- Use of complex derivatives and model-dependent valuation; and
- Interaction between credit, market and liquidity risks.

We believe that direct regulation over hedge fund risk taking is not practicable and probably not possible. Many hedge funds are domiciled in tax haven jurisdictions. While we license and regulate the fund manager, it is the fund itself that takes leverage, and engages in trading. Because the funds are not domiciled nor do they operate in Hong Kong, such activities are out of reach of the regulator.

To claim that we have direct regulatory supervision over these hedge funds would be dangerous; at a minimum it could give rise to a moral hazard problem with the investing public thinking we have a firm handle over such activities, when actually we do not. So we have to rely on market discipline which are the constraints placed on the hedge funds by their creditors, counter parties and investors.

We maintain active and, I would hope, open dialogues with the hedge funds, and also their prime brokers.

Prime brokers are directly regulated by us. So, there are a few things we expect them to do:

- Demand a sufficient level of risk transparency from their hedge fund counterparties to assess the overall risk profile;

- Make timely risk aggregation of different types of risk exposures to hedge funds and be able to assess their overall concentration risk to the hedge fund sector as a whole; and
- Develop appropriate risk analytics to better understand the linkages among different types of risks, and the likely interaction among market participants and across different but related markets under stressed conditions.

Concluding remarks

Finally, I would like to take this opportunity to say that we welcome quality hedge fund managers who have the proper risk parameters to set up in Hong Kong. We do recognize the role that hedge funds play in our market. They contribute to capital formation, promote market efficiency, and price discovery and add to market liquidity. Hedge funds also bring a wider investment choice for Hong Kong investors. And if they are properly used, they can help investors reduce their exposure to downside risks.

Hong Kong has a lot to offer to hedge funds, as it is the market with liquidity, openness, depth and access to the exciting Mainland market. In order to create a viable and thriving hedge fund industry, what is important is that we continue to work with hedge fund managers and the counterparties, creditors and investors of hedge funds to manage risks and develop the market.

Thank you.