

**Alternative investment funds: The new landscape
Speech at Alternative Investment Management Association
Members' Lunch**

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Introduction

Regardless of your view on the extent to which alternative investment funds contributed to the financial crisis or its effects, one thing is clear: In many countries, there has been a paradigm shift in the regulatory and supervisory approach towards managers of these funds and the funds' activities.

Many of you are no doubt grappling with the prospect of a raft of new regulations which will have significant effects on your business. Some of the measures are still at the proposal stage, others have been enacted. Some have been drafted and re-drafted over the course of lengthy debates, such as the European Alternative Investment Fund Managers Directive. Some set out frameworks with many details yet to be finalised, as is the case in various areas covered by the US Dodd-Frank Wall Street Reform and Consumer Protection Act.

The inevitable result for alternative investment fund managers and advisers will be increased regulatory scrutiny and reporting requirements in the major jurisdictions, as well as additional prescriptive requirements in some areas. For many of you, these sorts of measures don't just mean increased compliance costs. They have meant re-evaluating decisions such as where to base fund managers and advisers, how they and their personnel should be remunerated, where funds are domiciled and the target investor markets for these funds. And this is all against a background of considerable uncertainty still, since many of the regulatory changes are yet to come into effect.

Now of course debate has been raging for some time about the approaches being taken, the motivations for various proposals, their likely effectiveness and the consequences for various stakeholders. Several asset managers have voiced their frustration to me that they feel unfairly singled out by some of the new measures being proposed in some major jurisdictions, that the hedge fund industry in particular has become a scapegoat, an easy target. This is where I think industry organisations like the Alternative Investment Management Association (AIMA) play a vital role. For reasons I'll turn to now, I think the broad landscape has changed nevertheless, and one way in which alternative asset managers can ensure that their voices are heard, without necessarily seeking out a public spotlight for a particular manager or fund, is to take a collaborative approach through these sorts of groups.

One of the main reasons for the shift in approach towards these types of funds is the drive in most of these jurisdictions for increased transparency in relation to financial transactions and the parties involved in them. This is intended to benefit various market participants and also



to assist in identifying areas of systemic imbalance. The aim is not to single out hedge fund or private equity fund managers or investors, or the asset management industry in general. Rather, there is a perceived need for more information to be made available and for greater access or oversight where necessary, and this underpins many of the recent efforts by lawmakers and regulators in revisiting rules and regulations applicable to financial markets.

The regulatory approach in Hong Kong

The drive for transparency is reflected in efforts to provide for standardisation and central clearing of various types of financial transactions, greater disclosure and reporting obligations, both on a transactional level and for business vehicles and activities, and broader requirements for registration or licensing, supervision and inspection.

Each market has its own characteristics and local or regional considerations. So, as I've mentioned before, one of the challenges for lawmakers and regulators is trying to achieve overall consistency in implementation of the objectives identified at a global level while recognising that we don't all start from the same place on some of these issues.

In Hong Kong, we're committed to maintaining our world-class standards. We believe in a pragmatic and balanced approach. We have made some changes to our regulatory regime in the last couple of years. Some, but not all, of these changes were intended to address issues identified as a result of the financial crisis; we made other changes where we felt that they were needed to reflect developments in the marketplace, or streamline requirements, or to remove outdated provisions. In still other areas, however, our existing requirements have stood the test of time.

Current areas of focus

To take a couple of areas of recent focus in global and regional forums, we could look at requirements for licensing or registration of asset managers in Hong Kong and rules affecting trading of particular securities.

On the licensing or registration front, Hong Kong law already requires that asset managers carrying on business in Hong Kong be licensed with us. It has not been necessary for us to make wholesale changes to this aspect of our regulatory regime, since fund managers operating in Hong Kong are already subject to our regulatory supervision regardless of whether the funds they manage are offered to the public.

Of course, asset managers and advisers who are subject to our supervision in Hong Kong may also be regulated elsewhere, and thus we work with our fellow regulators around the world on matters of common interest. We have, for example, been carrying out joint inspections with the Securities and Exchange Commission of hedge fund managers who are both licensed in Hong Kong and registered in the United States.

Many of you are no doubt aware of the International Organization of Securities Commissions (IOSCO) initiative to collect information from hedge funds to facilitate assessment of systemic risk, and we are participating in that. Even in this area, I am hearing complaints that different jurisdictions are asking for slightly different information in some areas. I mentioned earlier that one of our challenges is to ensure as consistent an approach as possible in general standards applicable to major markets while dealing with local-level issues. For our



part, we try to ensure that there's as much standardisation as possible in things of this nature. In Hong Kong, of course, the Securities and Futures Commission (SFC) has previously conducted other surveys of Hong Kong-licensed asset managers, such as our annual Fund Management Activities Survey and our periodic survey on the hedge fund activities of SFC-licensed managers (which was last conducted in 2009). We aggregate the data we receive in response to these surveys and publish reports on the results, which we believe helps all stakeholders, including the fund managers, by increasing the level of transparency across the industry. I'll come back to a couple of interesting points from previous survey results in a few moments.

There have also been changes to rules covering trading of securities and other instruments in many places, and of course these sorts of changes affect asset managers too.

We have seen rules imposed around short selling of securities. We are also seeing pushes for standardisation of financial transactions where possible, to enable better containment of risks. There are efforts afoot in most major jurisdictions to provide for central collection of information about trades in various different types of financial assets, and to examine clearing and settlement arrangements and provide for centralised clearing of trades in some areas.

Hong Kong was one of the few developed markets that did not impose emergency short selling regulations in the last few months of 2008. Our rules around short selling of securities have been in place for some time now; in fact, they were introduced in 1998 in the wake of the Asian financial crisis, after the Hong Kong government intervened in the stock market in response to speculative pressure on Hong Kong's currency and abusive short selling of Hong Kong stocks. Short sales effected through the stock exchange must be covered and can be executed only in designated securities. And these trades are subject to the "uptick" rule, which essentially means that a short sale cannot be made below the best current ask price. The uptick rule in particular was controversial when first introduced. Over the years there were various submissions by market participants that the time was ripe to relax the rules, but ultimately we didn't do this – and events in 2008 reaffirmed our approach.

In terms of transparency, short sales are required to be flagged or identified upon their entry into the exchange's trading system and, in addition to this, we are in the process of implementing a short position reporting requirement to assist in identifying positions which might affect market stability. The obligation will be triggered once a short position reaches 0.02% of the issued share capital of the relevant issuer, or the value of the short position amounts to or exceeds \$30 million, whichever is lower. In setting the threshold we wanted to capture substantial positions but avoid imposing undue compliance burdens by setting the limit too low. Obviously, although we took into account the thresholds set in other markets, the characteristics of the local market were very important here. We also took a risk-based approach in proposing an initial list of shares to be covered by the reporting regime.

On a broader note, we continue to work with the Hong Kong government and other regulators in many of these areas of international focus to ensure that Hong Kong's approach is appropriate for its market.



The Hong Kong market

Our statistics indicate that numbers of licensed hedge fund firms and their licensed individuals have both increased significantly over the last four years – by about 60% in the case of firms and 50% in the case of licensed representatives. During the first nine months of 2010, we received almost as many hedge fund-related new corporate applications as we did during the whole of 2009. As of the end of September 2010, we had 307 licensed hedge fund managers with 2,584 licensed individuals working for these firms. Both our hedge fund survey and our general Fund Management Activities Survey of 2009 indicated that international investors continued to use Hong Kong as a platform for investing in the region.

Despite difficult market conditions, the fund industry in Hong Kong has continued to adapt, and to cater to investor demand in new areas. China's latest steps in its efforts to internationalise its currency have been met with enthusiasm. Both the range of potential investment avenues, transactions and services in renminbi (RMB) and the pool of potential end-users are increasing rapidly, providing opportunities for both sides. The door has now been opened for general fundraising in RMB in Hong Kong and for payments such as subscriptions, redemptions, coupons and premiums to be made in RMB in Hong Kong, and the avenues for investment in the currency both here and on the Mainland are expanding.

These are challenging times for business, and, as I mentioned at the outset, I think that some of the rules for alternative asset managers might have changed for good. In debating the extent or effectiveness of some of these changes, it's important not to lose sight of the overall objectives, particularly the desire for a greater amount of information to be made available, either to regulators and prudential supervisors or to the market as a whole. It's also important for stakeholders to engage in this process, to voice concerns that they may have, to contribute suggestions where they feel that objectives might be better achieved by different means. Many of you may not have felt the need to involve yourselves previously, or may have refrained from doing so for various reasons. Hedge funds traditionally have preferred to keep to themselves, doing their own work, not quite willing to engage with regulators and policy makers. While that might have been acceptable when the industry was small, it is sensible, now, for the industry, which has grown to the size it is today, to show that they are prepared to engage, to be more transparent and more socially responsive. Where you feel that your interests are best served by collective input, or where you wish to provide input to a public debate as a group, industry associations can provide a useful platform and channel of communication. But responses to or input on policy matters can be formal or informal. I have said many times that our door is always open, and I genuinely mean it.