

Keynote speech at AIMA Policy and Regulatory Forum

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Introduction

Thank you for inviting me here.

We have just heard from a panel of distinguished speakers sharing their insights into policy and regulatory issues in the alternative investment space. Quite rightly, much of your discussion today will focus on the “what” and “how” questions, dissecting the rules and regulations that are being put in place, and contemplating compliance solutions. These are no doubt important questions, not least because many of the new rules will have a major impact on the way you do business, and your bottom line.

Since we do not often have such a large gathering of regulators and hedge fund professionals all in one room, I thought it would be useful for me to take a step back from the more technical issues, and use this occasion to share with you the regulators’ thinking, and explore how the hedge fund industry could work more closely with the regulators. It has always been my belief that a frank, open dialogue between the regulator and the regulated would help the industry develop in a healthy manner, and provide reference points for us as we write rules to regulate the industry and the market. Many of you here today have picked Hong Kong as your base. You therefore have a stake, as much as we do, in maintaining the Hong Kong market’s integrity, depth and vibrancy.

In the last three years we have seen a strong inflow of firms, among them hedge funds and other alternative managers, eager to tap the opportunities that open up as mainland China continues to liberalise the use of its currency and allow liquidity to leave its border. To capture those opportunities, our market must offer not just choice and talent but also proper investor and systemic protection. I will also share with you my thoughts on why some of the recent reform developments will help in these areas.

The current hedge fund regulatory regime

First, let’s clarify the facts. While across the global markets there has been a slew of new legislation and rules since the 2008 financial crisis aimed at bringing hedge fund managers under the oversight of regulators, we in Hong Kong have always regulated hedge fund managers who operate in our market. Whether you manage assets for institutional clients or you offer your products to the public, without exception you are required to be licensed with, and supervised by, the SFC.

Our rules and regulations are clear, transparent and consistently applied. We do not wish your compliance costs to be higher than they need to be. Our statutory functions are to protect investors and maintain market integrity. As you will have seen from the proceedings



we brought in the Hong Kong courts against Tiger Asia Management LLC, a New York-based asset management company, we will deploy every tool we have under the law to combat market manipulation and insider dealing. We also require our licensed asset managers to adhere to a Code of Conduct, under which they must act prudently and professionally, avoid and manage conflicts of interests, adhere to stringent internal controls, and put the interests of their investors first.

I believe we have got the balance of hedge fund regulation about right. In the last two decades, Hong Kong has become an important hedge fund hub in the Asia Pacific region. Our latest hedge fund manager survey showed that hedge fund assets under management or advice in Hong Kong reached US\$63.2 billion as at 30 September 2010, an increase of 14% from the previous survey in March 2009. The number of licensed hedge fund firms has risen significantly too, by about 83% since 2007.

But events that unfolded during the 2008 financial crisis told regulators around the world that a firm-focused regulatory regime that looks only at prudential and conduct issues of each firm is not sufficient. Because some firms are very big, and because they could be seriously connected financially, regulators need to see the whole jigsaw piece to understand the systemic implications of this connectedness, and devise tools and processes to manage the risks both locally and globally. In other words, apart from prudential and conduct issues, the regulators need to monitor financial stability and systemic risk as well. Although Hong Kong weathered the crisis relatively well, the lessons learnt are no less relevant for us because our market and its players are global.

Systemic concerns

Even though no hedge fund has been designated by the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (Basel) as a global systemically important financial institution (Global SIFI), the hedge fund industry is increasingly attracting regulators' attention. The industry has metamorphosed from a collection of boutique, specialist firms into a matrix having within it some very large players. The largest manager now has over USD70 billion under its management. In addition to their size, there is also the prospect of substantial connectivity between hedge funds and the major players in the financial industry: prime brokers, banks, securities lenders and other counterparties who write or trade derivatives with hedge funds. In times of extreme market stress, if a big hedge fund were to fail, that could bring down the whole network.

Exactly how connected a big hedge fund is in the system and how it could affect the market are anyone's guess. To regulators, this is the missing piece in the jigsaw. There is no reliable data on hedge funds' exact size, the level of leverage that they employ, the volume of derivative transactions that they are involved in and their counterparties, etc. The lack of reliable information on such a crucial and highly interconnected segment of the market is inhibiting regulators' ability to chart the nexuses that link up the financial world, thus making it difficult to assess impact and map out contingencies.

We have been in a similar situation before. In the run up to the 2008 financial crisis, pundits applauded the alchemy of securitisation and other financial innovation. They believed these would disperse risk away from the centre of the financial system, thus making it more robust. This turned out to be illusionary. Much of the risk continued to reside within the handful of institutions that were "too big to fail". A few factors prevented regulators from gaining a true and accurate understanding of the situation. The risk slicing-and-dicing was so convoluted



that those in charge of risk monitoring could not see the whole picture. In hindsight, we now know that there was one crucial regulatory blind spot – AIG. The insurer accumulated huge potential liabilities that went unnoticed and in the end it had to be bailed out by the US government. As you can imagine, governments and regulators are keen to avoid a repeat of this. The way forward therefore is to seek domestic and global solutions to aggregate and share information, minimize systemic risks, strengthen macro-prudential regulation and international co-operation.

Reforms seeking more information for the regulators

Post 2008 financial crisis, the International Organization of Securities Commission (IOSCO) formed a task force on unregulated financial entities to examine the systemic risk posed by hedge funds to capital markets and the adequacy of current regulations. We participated in that group. IOSCO ultimately decided that its member jurisdictions should carry out a co-ordinated IOSCO hedge fund survey to collect important data to identify systemic risk and weakness.

Conducting and publishing regular surveys on our hedge fund managers has been a regulatory tool that we adopted as early as 2006 to improve the transparency of our hedge fund industry. In our surveys we asked for information concerning background of manager, size of asset under management, source of funds, geographical breakdown of investments, etc.

The IOSCO task force developed a survey template which adopted parameters broadly similar to those used in the SFC hedge fund manager survey, but goes further to seek from hedge funds with larger AUM more granular information on trading, clearing, leverage and exposures. In September 2010, in parallel with other IOSCO member jurisdictions, we conducted the first IOSCO co-ordinated survey. Not every jurisdiction was able to require all their hedge fund managers to complete the survey questionnaire and thus the aggregate data was not as complete as we would have liked, but the exercise overall was useful. We are now revising the survey template to take in lessons learned in the first survey to improve its comparability. The next survey will be conducted in September 2012. We hope that you will all participate.

Other financial reforms that may impact the hedge fund industry

While in the hedge fund space, our focus has been to improve the quality of information collected, other financial reforms will also have an impact on hedge fund operations. These include international efforts spearheaded by G20 leaders and co-ordinated by FSB on regulation of shadow banking, Global SIFI, over-the-counter (OTC) derivative trades, and IOSCO's initiative on increasing transparency of short selling activities.

Of course, not every jurisdiction has the same imperative for financial reform, or the same set of issues. However, we believe that it is important that the Hong Kong market embrace international standards. Many of our market participants are members of international groups. Their services, trades and assets are integral parts of a global business. The Hong Kong regulatory piece, therefore, needs to broadly synchronize with those of other markets.

We believe that the standards set should be well thought through and reasonable. For this reason, we actively participate in international forums, at FSB, IOSCO task forces and workgroups, and in bilateral engagements with regulators of major markets – in the US, EU and Asia, to make sure that Hong Kong's views are taken into account.



(i) Central clearing of standardized OTC derivative contracts

As you know, the G20/FSB has made firm commitments on central clearing and reporting of OTC derivatives. The idea behind this is the desire to avert another AIG-like incident. We consulted the market in October 2011 on a proposal to require, initially, certain interest rate swaps and non deliverable forwards that have a Hong Kong connection to be cleared through qualified central counterparties. In addition, we require these trades, whether or not centrally cleared, to be reported to a Hong Kong trade repository. We are now preparing legislation and rules for this proposal. Our objective is to improve overall transparency in the OTC derivatives market, protect the market against abuse, reduce counterparty risks and ultimately, enable regulators to better assess, mitigate and manage systemic risks.

Of course, there will be an extra compliance cost here in OTC trades going forward, but the good thing is, the different jurisdictions involved are working hard to ensure a broad uniformity of regimes to avoid regulatory arbitrage. We have been working with the Hong Kong Monetary Authority (HKMA) and different parts of the market on these proposals. I would encourage you to continue to provide your views and suggestions as we move into the legislative stage.

(ii) Short selling reporting

Another area that is highly relevant to the hedge fund industry is the regulation of short selling, a strategy that many of you employ. Many jurisdictions banned short selling during the financial crisis in the hope of ensuring the stability of their markets and protecting their systemically important financial institutions. Such measures probably caused disruptions to the operations of some of you.

Here in Hong Kong, we recognised the role that short selling could potentially play in enhancing market liquidity and efficiency. Our assessment at the time was that the short selling regime that we put in place after the Asian financial crisis would continue to be effective and the tools that we gave ourselves were sufficient. As a result, we held our ground and avoided overreaction.

In 2009 we commenced a review on ways to enhance transparency of short selling information to give regulators a fuller picture of short selling activities. The key measure that we are introducing is to require the reporting, weekly at the close of market, of a net short position when it reaches 0.02 % of the issued share capital of certain listed companies, or HK\$30 million in value, whichever is lower. The new rules are now going through the legislative stage, and we expect that they will be implemented this summer. This is part of an international drive. Other markets have implemented similar reporting requirements with different thresholds - some higher, others lower.

(iii) Regulatory reforms that are in gestation

Other regulatory initiatives that affect the rest of the financial sector, such as those relating to banks' relationships with hedge funds and the capital charge on transactions with hedge funds, will also have some impact on the industry. I co-chair, together with a representative of the US Federal Reserve Board, an international working group on the margin requirements for non-centrally cleared derivatives under the auspices of Basel and IOSCO. The aim is to recommend a set of margin requirements to be adopted across different markets for bilateral trades that are not centrally cleared. Hedge funds, being users of novel financial instruments, would no doubt be affected. Our working group is tasked to issue a



consultation paper in June this year. I hope that the industry will actively participate in the deliberation process, to ensure that our proposals are effective and practical.

Hedge fund transparency

The hedge fund industry has a strong track record of responding to changing market conditions, including regulatory demands. There is, however, one particular area that I would urge you to do more, and that is transparency.

I understand that many of you have reservations over publicity. After all, hedge fund products are sold to a limited circle of investors. The hedge fund is not systemically important. However, we are seeing a gradual expansion of the hedge funds' investor base, from the super rich and endowments to pension funds and funds of funds. Whether you like it or not, the high profile successes, or failures of hedge funds and their star managers reported in the media have forever changed the way the public looks at this sector. The days of quietly trading and making money in your garage away from the prying eye of the public are gone. They went, if not before then certainly when the public learned of fraud scandals like Madoff, and insider dealing sentences like the 11-year prison term handed down to Galleon's Raj Rajaratnam. Some hedge fund managers tell me that greater transparency could reveal their trading strategies or proprietary technologies, or could expose them to populist or political backlash. But these issues are not confined to hedge funds. Players from other financial and non-financial industries face, and successfully manage, such challenges.

More communication fosters trust. Investors who hand over their money would understandably want to know more about how it is used and safeguarded, and that their hedge fund managers are completely upfront with them.

And it is not just investors. We would like you to be actively engaged with regulators as well. The regulatory landscape of the financial industry is undergoing seismic shifts. The ultimate goals of the reforms are clear and have been agreed by world leaders. But how we get there is still being mapped out. We hope to find the most practical solution, one that would deliver results with the least disruption to the industry. To that end, we need your ideas. AIMA has been willing to engage with us in our policy deliberations and reform proposals. For this we are very appreciative. We would like each of you to know that our doors are always open and that we would benefit from the opportunity of hearing your views whether on the global economy, market trends, or our regulatory proposals.

Opportunities for hedge funds managers in Hong Kong

I have been talking quite a bit about regulation and how the industry should respond to it. Before I wrap up, I would like to spend a few minutes to look ahead at the opportunities that are available to the industry in Hong Kong.

While current investments in mainland China represents just over one-tenth of the hedge fund assets managed in Hong Kong, I trust that many of you who are based here have in mind opportunities arising from the liberalisation of the RMB and gradual opening of the Mainland's capital market.

Hong Kong is of course best placed to capture these opportunities. I need not repeat here the well rehearsed arguments in Hong Kong's favour – like the rule of law, pool of talents, world class infrastructure, etc. Let me, instead, explain it in real commercial terms. Hong



Hong Kong is the Mainland's offshore international market that could access the rest of the world for the Mainland while the Mainland is not ready to do so itself. The Mainland therefore has a strategic interest in Hong Kong's continued development as an international financial centre. Once we understand this relationship, we can quickly see why Hong Kong enjoys clear and distinct advantages in the development of RMB business outside the Mainland, and why we are given special opportunities to access the Mainland market and its liquidity

Hong Kong already provides the best window for taking part in the Mainland's growth. Almost all the Mainland's major enterprises are listed in Hong Kong. We have a vibrant offshore RMB market, with the largest pool of RMB liquidity outside the Mainland. In 2011, the RMB bond market in Hong Kong recorded a year-on-year growth of 200%, adding about 80 issuers and more than RMB100 billion worth of RMB bonds. This is the only place outside the Mainland where the Chinese Ministry of Finance has issued bonds – first in 2009 and thereafter on a regular basis.

These opportunities represent only a small slice of the cake: RMB is still a relatively novel class of investment for overseas investors. Because the Mainland's capital account is still closed, most Mainland investment opportunities remain off limits to outside investors. It has been reported that currently only about 0.8% of the Mainland's equity and bond markets combined is held in foreign hands. These restrictions create a niche for those who are resourceful yet nimble enough to navigate the many hurdles to get a piece of the action. Hedge funds and alternative investment managers may well be able to tick the boxes.

We are all aware of the Mainland government's concern over the flow of speculative money and their belief, which in fact is becoming more widely shared among governments around the world, that finance exists to serve the real economy. Some of you may well wonder if hedge funds would not be seen favourably.

In my view, this does not necessarily have to be the case. Although many have stressed the speculative and destabilising nature of hedge funds, there are hedge funds and alternative investment managers with a strong record of successful long term investment. They acquired and turned around distressed assets in different corners of the world and, in the process, made handsome profits. I understand that some of you are active, and have done well, in non-performing assets in the Mainland. You all chose to set up here for good reasons. Being close to the Mainland is one of them.

Conclusion

Let me now end on this positive note. The global trend towards more regulation on hedge funds and alternative investments is irreversible. I would like to enlist your help to make the new regime work better for everyone. The hedge fund industry is about talent and creativity. I hope that you will apply these skills to building better transparency regarding yourselves and your business. For those of you who do so, the prospects are bright.

Thank you.