Regulatory perspectives on Hong Kong as the largest Asian hedge fund hub

Keynote speech at AIMA APAC Annual Forum 2022

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Good morning. Thanks for the invitation to deliver the keynote address for the AIMA APAC Annual Forum 2022.

This event was originally planned for March this year, but was overtaken by a severe wave of COVID-19. Yet despite a series of local and global challenges on multiple fronts over the past few years, Hong Kong's position as a leading international financial centre connecting to the Mainland markets has grown in importance. We have seen robust growth in Hong Kong's asset management sector. Today I want to survey the hedge fund landscape as observed from data collected by the Securities and Futures Commission (SFC), and speak about some recent policy developments as they relate to market resilience, virtual assets and sustainable finance.

The hedge fund sector in Hong Kong

Last year, in conjunction with an initiative of the International Organization of Securities Commissions (IOSCO) to collect data on investment funds, the SFC conducted a survey of licensed hedge fund managers. I would like to take this opportunity to thank you all for your participation in the survey.

We note from the Alternative Investment Management Association's (AIMA) recent publication, *Alternatives in Hong Kong,* that Asia Pacific's alternative asset class is growing faster than anywhere else in the world, and Hong Kong is the largest hedge fund centre in the region.

This growth is also evident from our survey data. Between 2018 and 2020, the number of hedge funds increased by roughly 20% to more than 1,400. During this time, the total assets under management (AUM) managed by hedge funds surged by around 48% to US$287 billion. Nearly 90% of the survey respondents reported Hong Kong as their headquarters, and their total AUM was 70% of the total hedge fund sector AUM as at the end of 2020. This is in sharp contrast with the situation over a decade ago, when our survey found that the managers with the largest AUM were mainly global firms based overseas.

In terms of hedge fund strategy, while equity long-short has remained dominant in the local landscape over the years, an increasing number of large managers are now running credit or

Note: This is the text of the speech as drafted, which may differ from the delivered version.

multi-strategies. Consistent with the trend identified by AIMA, we see increased diversity in our hedge fund sector, with a variety of equity and credit-related strategies gaining traction.

The financial data reported to us also reflects very solid sector growth. For the asset management industry overall, total income has grown significantly—more than 50% over the past two years. Hedge fund managers regularly make up around 20% of the sector's income.

This is evidence that the hedge fund sector is both diverse and strong, and it is now a core pillar of Hong Kong's asset management industry. It helps foster the development of a dynamic capital market and support Hong Kong's positioning as a premier wealth management and risk management centre in the region.

Resilience and non-bank financial intermediation

The COVID-19 pandemic put the global financial system to its greatest test since the G20 reforms were put in place following the 2008 global financial crisis. Thankfully, the global financial system weathered the pandemic as a result of its greater resilience together with effective policy responses. However, the March 2020 market turmoil also highlighted vulnerabilities in several segments of the market and reminded the global community of the importance of enhancing market resilience, in particular in non-bank financial intermediation (NBFI).

The growth of NBFI, including the hedge fund sector, has resulted in a larger volume and variety of financial risk being held outside the banking sector. The "dash for cash" incident in March 2020 brought into focus the importance of market participants' liquidity management, and in particular their readiness to meet margin calls. This also means that financial resilience increasingly relies on the ability of investors to effectively manage market, credit and liquidity risks in times of stress.

The dangerous combination of leverage and concentration was highlighted in the Archegos incident a year later. This was a case where a hedge fund took on outsized, concentrated bets that went the wrong way, leaving a trail of losses among prime brokers that had lent to the fund to build up its position.

Discussions subsequent to the Archegos incident have focused on enhancing the transparency of hedge fund positions and the ability of regulators to detect concentration risks in our markets. Since the 1997-1998 Asian Financial Crisis, the SFC has enhanced our market surveillance tools to specifically monitor the build-up of large and concentrated positions in the market.

Our monitoring tool box was greatly expanded with the implementation of the mandatory reporting of over-the-counter (OTC) derivatives starting in 2015. The use of trade repositories (TRs) has given us a line of sight into the build-up of exposures and concentration risk in the OTC market. Our tool kit has also been purposefully retooled to capture OTC equity derivatives data in a more granular manner—that is, at the holder level, the prime broker level and the underlying security level—to spot outliers and potentially take precautionary action.

So far, our observation is that the aggregate exposures and risk positions taken by market participants have been stable and diversified. Our hedge fund survey data indicated that the aggregate gross leverage used by qualifying hedge funds in Hong Kong was 7.9, a level below the global average of 12.4 at the end of 2020[1]. Of course, averages can be misleading. We will remain vigilant and follow up on any alerts—whether on or off market—to ensure our financial market is resilient in times of volatility.

The SFC has also been active in this area at the international level. We initiated a study to explore the use of TR data for systemic risk monitoring and co-chaired the joint workstream of the Financial Stability Board (FSB) and IOSCO on TR data. The workstream has developed common quantitative templates for participating jurisdictions to analyse equity swap data and fund data to gauge concentration, use of leverage and interconnectedness. The quantitative templates would help enhance risk assessment and cross-border cooperation in the monitoring of NBFI among the jurisdictions involved.

Risk management and hedging Mainland assets

An important competitive edge Hong Kong has as a hedge fund centre is its role as a gateway to China. This is reinforced by our ongoing journey expanding mutual market access with the Mainland and developing corresponding risk management tools for hedging Mainland assets. Just last week, the China Securities Regulatory Commission (CSRC) announced that foreign companies primary-listed in Hong Kong would be included in Stock Connect.

Over the past few years, you have witnessed the success of Stock Connect and Bond Connect. Last year, both of them registered record average daily turnover. While the average daily turnover of northbound and southbound Stock Connect has declined slightly, they regularly make up over 5% of A-share market turnover and over 10% of Hong Kong stock market turnover. The growing size of exposure to A-share equities and Mainland bonds has spurred a significant demand for risk management tools.

The launch of MSCI China A 50 Connect Index Futures last October has provided a simple yet useful tool for investors to manage their A-share exposure in Hong Kong. In recent months, this contract's average daily turnover exceeded US$1.1 billion, and its notional open interest averaged around US$1.6 billion. In just 11 months, this new contract accounts for about 20% of all offshore A-share futures trading. This has undoubtedly been an instant success.

Also, the CSRC announced its support for Hong Kong to introduce treasury bond futures. This followed on the July announcement of Swap Connect, which marked another milestone in Mainland-Hong Kong mutual market access. Global investors will be able to access the Mainland interbank derivatives market from Hong Kong. Swap Connect and the offshore treasury bond futures will both provide efficient ways for global investors to manage interest rate risks arising from their Mainland bond investments, and this will enable them to participate more broadly in the vast Mainland bond market.

All of these new hedging tools will encourage long-term investments in Hong Kong by providing global investors with an additional liquidity pool for managing their risk exposure to Mainland markets, particularly to ease sell-off pressure amid market volatility. This enhanced ecosystem will attract new capital, promote stable market development, and further anchor Hong Kong's position as a leading risk management centre.

[1] See IOSCO Investment Funds Statistics Report published in January 2022.

SFC 證監會

Virtual assets

Another takeaway from the SFC's hedge fund survey in 2020 suggested that virtual asset investment was a minority sport. But that might be changing. AIMA's global survey conducted in the first quarter of this year found that among 89 respondents, one in three "traditional" hedge funds was investing in virtual assets, with a further 30% looking to invest in such assets. This compared to only one in five hedge funds investing in virtual digital assets a year earlier[2].

It has become clear that with an increasing number of institutional participants, virtual assets are entering the mainstream of our financial system. But this largely unregulated sector still has a long way to go before it can be considered mainstream. One just has to look at recent events. The collapse of LUNA and Terra, along with slumping cryptocurrency prices, led to the default of crypto hedge fund, Three Arrows Capital, which, like Archegos, had amassed big bets turbo-charged by leverage. The demise of Three Arrows Capital brought some of the largest crypto lenders to their knees, shining a spotlight on how fast and wide risks can be transmitted to other parts of the crypto ecosystem. History just repeats itself—remember the fall of Long-Term Capital Management[3] in 1998?

In response to the recent turmoil, many jurisdictions have tightened or are planning to tighten their regulation of virtual asset activities. The FSB has highlighted the importance of addressing the potential financial stability risks posed by crypto-assets. It noted that "*an effective regulatory framework must ensure that crypto-asset activities posing risks similar to traditional financial activities are subject to the same regulatory outcomes*"[4].

The SFC has been a strong advocate of "same business, same risk, same rules". In fact, we have been at the forefront since we formulated an opt-in approach to regulate virtual asset trading platforms (VATPs) in 2018[5].

The anti-money laundering amendment bill which has just been introduced to the Legislative Council would make licensing by the SFC mandatory for any entity operating a centralised virtual asset exchange in Hong Kong or targeting Hong Kong investors. As an illustration of our regulatory approach, not only anti-money laundering but also market integrity, cybersecurity, safe custody of assets and operators' conflicts of interests will be regulated in a similar manner as regulated entities providing brokerage and automated trading services.

Cognisant of the fact that virtual asset investment is here to stay, the SFC issued a circular[6] jointly with the Hong Kong Monetary Authority (HKMA) in January this year to provide guidance to traditional financial institutions that engage in virtual asset-related activities. The circular covers product distribution, dealing services under omnibus account arrangements and advisory services—mainly to professional investors. Besides approving licensed fund managers to manage virtual asset funds, we have already approved the first broker to conduct agency dealing in virtual assets via an SFC-licensed VATP. A licensed broker also recently conducted a private security token offering to distribute security tokens to professional investors in Hong Kong.

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[2] See the 4th Annual Global Crypto Hedge Fund Report 2022.

[3] Long-Term Capital Management L.P. was a highly leveraged hedge fund which borrowed heavily from large financial institutions to leverage its bets. Following the 1998 Russian financial crisis, the hedge fund suffered substantial losses. To prevent the hedge fund's imminent collapse and far-reaching consequences in financial markets, the US government had to facilitate a bailout, which was financed by major creditors.

[4] See the FSB's statement dated 11 July 2022.

[5] Commenced in November 2019.

[6] See the Joint circular on intermediaries' virtual asset-related activities dated 28 January 2022.

Globally, as other regulators are formulating newer and tougher regulation, the SFC has consistently applied a risk-based and "same business, same risk, same rules" approach. The predictability and clarity of our current framework would provide a solid foundation for virtual asset service providers to establish locally and for traditional financial institutions to interface with these providers to offer a diversity of virtual asset products to clients. It is now clear that the sooner the crypto industry embraces regulation, the faster it can become part of mainstream finance.

Sustainable finance

Next, I will move on to a subject of growing significance in the asset management space—sustainable finance. Climate change is a reality, and extreme weather now threatens every aspect of our lives. When the whole world is experiencing the dramatic impacts of extreme weather and the aftermath of these events, including flooding and energy shortages, the financial sector has to do its part in achieving the net zero target. Alternative asset managers have been at the forefront of tackling climate change. Your institutional clients such as pension funds and sovereign funds now have a better understanding of their role in financing a transition to a low carbon economy.

As a financial regulator, the SFC was among the first in the region to adopt a mandatory approach to requiring fund managers to incorporate climate-related risks in their investment decisions, risk management and related disclosures. After extensive consultation with the asset management industry, including AIMA, the SFC amended our Fund Manager Code of Conduct to provide guidance in this regard. This established our ESG[7] leadership as an asset management hub. And just last month, the first phase of the new regulatory requirements came into effect, with quantitative disclosure expected in mid-2023.

The demand for reliable ESG ratings and data products are constantly growing. We share the industry's concern about low correlation and comparability among the ratings and products provided by different ESG service providers. Without adequate transparency from the providers about the approaches and methodologies they use, the quality of the risk assessment performed by fund managers may be called into question. As a next step, we are reviewing fund managers' use of ESG ratings and data product providers, beginning with a fact-finding exercise to understand the business operating model of these ESG service providers as well as current market practices of fund managers when selecting and engaging with these providers. The study will help us prepare guidance for the asset management industry on using ESG service providers.

Further, we noted the concerns expressed by AIMA and some other industry participants about the lack of green finance talent in Hong Kong as well as the limitations of the available data. The SFC and members of the Green and Sustainable Finance Cross-Agency Steering Group are working on different initiatives to address these concerns. In particular:

- On the issue of data availability, the SFC, together with the HKMA, is planning to create a free and publicly accessible greenhouse gas emissions estimation tool, with clearly disclosed methodologies, that companies can use as an alternative source of information.
- On capacity building, we are working with our fellow regulators and the HKSAR Government on a new Pilot Green and Sustainable Finance Capacity Building Support

[7] Environmental, social and governance.

Scheme. This is a subsidy scheme to encourage industry professionals to attend courses and build up their knowledge of green and sustainable finance.

All of these initiatives will help fund managers embrace sustainability. The SFC will continue working with the asset management industry to boost Hong Kong's position as a regional and international green finance centre.

Conclusion

The last point on capacity building brings me back to the AIMA report on Hong Kong which identified developing, attracting and retaining high-quality international talent as one of the six pillars that were crucial for Hong Kong's success. I could not agree more.

Unquestionably, Hong Kong is now facing some big challenges, which are mainly pandemic induced. In my interaction with senior officials of our Government, I have no doubt that the new Administration is acutely aware of the importance of talent retention in the financial sector and is working tirelessly to address your concerns—including hotel quarantine time for inbound travellers. With a roadmap and direction of travel much clearer now than before, let's work together to build Hong Kong into an ever bigger and stronger private fund centre.

Thank you.