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Speech

Opening Regulatory Keynote
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Thank you Jack[1] and AIMA for inviting me here today.

I appreciate the opportunity and privilege of giving the “Opening Regulatory Keynote” to this conference. When I sat down to think about what to say, it struck me that my audience are mostly hedge fund managers, and that made me smile. It wasn’t that long ago, maybe only 10 years ago, that the industry would rather have as little to do with regulation and regulators as possible. You were outside the regulatory radar and worked hard to keep it that way. Yet, here I am today, a regulator, giving a keynote speech to AIMA. Things certainly have changed and I believe for the better.

With AIFMD in Europe, the Dodd-Frank Act in the U.S., and the ongoing debate over the systemic implications of investment funds at the international level, regulation and increased oversight has set the tone for hedge fund activities. Whether or not this is a good thing is something I’m sure many of you grapple with. My view is that regulation, if done in an appropriate and measured way, will have a positive effect on the long term growth of the industry. Allow me to spend the next 15 minutes elaborating on this point.

General market conditions

Let’s start by taking stock of where we are.

The past few years have not been kind to savers worldwide. Fears of a collapse in the global economy following the 2008 financial crisis have prompted policymakers to take drastic action. Central banks slashed interest rates and embarked on massive quantitative easing. Returns to savings hit rock bottom, sometimes even reaching negative territory. Investors were understandably not happy.

On top of that, stock markets have boomed over the past few years. The market was flushed with liquidity and share prices rose to dizzying heights. Yet not everyone had the appetite to get in on the action, especially those investors who were still licking their wounds from the losses they suffered in 2008. The unfortunate fact is that the financial crisis eroded trust between customers and financial firms. Investors remain sceptical about the sustainability of a rampant stock market that seemed to be bolstered by not much more than central bank rain making. And you can guess what came next. When rumours started swirling in 2013 about an imminent tapering of the Federal Reserve’s quantitative easing program, stock markets worldwide duly fell.

[1] Jack Inglis, CEO of AIMA

In 2014, events seemed to have taken a turn for the better. Recovery in the U.S. appeared more sure-footed, unemployment continued on its downward trend, and corporate profitability looked healthy. But market-changing events always seem to be just around the corner. First there were geopolitical tensions in Europe. Then there were concerns over the Chinese economy, the effectiveness of Abenomics and the health of other emerging economies. More recently, oil prices have tumbled and you only have to witness the massive correction in the Shanghai stock market a few day ago to see that all these events are causing major market gyrations. The poor stock market investor is completely befuddled and seems to always be on the wrong side of the market.

This is because the only certain trend is that of uncertainty and volatility. And unfortunately for those investors, investment options are few. Even the darling of many Hong Kong savers – stashing money in RMB term deposit accounts – looks less attractive as the rising streak of the currency seems to be nearing an end.

Hedge fund industry performance

This uncertainty and volatility is exactly the kind of environment in which we expect the hedge fund industry to prosper. After all, the industry promises all-weather returns and investors seem to agree. Market studies showed that 2014 was one of the hedge fund industry's best years in terms of investment inflows. In mid-2014, hedge fund managed assets reached USD3 trillion, a record high.

Looking beneath the surface, though, the industry's performance has been less rosy. The Financial Times reported that in 2014, only 22 hedge funds were able to beat the 14% return of the U.S S&P 500 index. Admittedly, 14% is a rather tough benchmark, and such a spectacular return may well be a one-off. But even if we look at a more extended period, the average annual hedge fund return after fees was about 3.6%. This is less than the return from simple investment in stocks and bonds over the same period.

Performance aside, concerns over costs, complexity and opacity continue to plague the hedge fund industry. In September last year, Calpers, the largest public pension fund in the U.S., announced that it was exiting its USD4 billion hedge fund investment. Earlier this year, the Dutch pension fund PFZW, which had aggregate assets of USD185 billion and one of the top three public pension funds in Europe, announced a similar decision. Both cited cost and complexity as the key reasons behind the switch.

Every cloud has a silver lining. Results from a recent survey of over 100 of the world's largest institutional investors showed that 26% of them planned to increase their hedge fund exposure this year, compared with 16% that were planning a cut. Many institutional investors continue to view hedge funds as a way to generate returns with less risk than a traditional stock and bond portfolio.

The regulator's perspective

Regulators also see value in hedge funds. The proposition of generating return regardless of market conditions is appealing, at least in principle. At the very least, hedge funds broaden investor choice.

Regulators welcome diversity provided that financial intermediaries including fund managers put investors' best interests first. So how do you prove your good intentions to your investors and the regulators who are there to protect investors? There are no shortcuts. You do so by continuously demonstrating robust risk management and providing clear and appropriate disclosure to your investors. This is also how you gain investors trust and confidence which must be the cornerstone of any viable business.

These very important considerations were the key reasons behind our introduction of the retail hedge funds guidelines in 2002 and they are just as relevant and important today.

I mentioned at the beginning that I will try to explain the positive synergies between regulation and industry efforts. This is how I see it. I believe the longer term health of the hedge fund industry rests on two pillars. The first is return. The second is governance. In terms of dictating returns, there is really not much regulators can or should do.

Governance is another matter. Regulations aim to introduce best practices in areas such as disclosure, valuation, and protection of investor assets. This has immense value - we are told time and again that investors are reassured and feel more confident with fund managers that come from jurisdictions with credible and robust regulatory regimes.

More directly, regulatory efforts are useful in shedding light on and improving the transparency of some otherwise opaque industry segments. In Hong Kong’s case, for example, the Commission has been conducting regular surveys of the hedge fund industry since 2006. The information is useful not just for regulators, but also for existing and prospective investors in understanding industry developments and making investment decisions.

The Hong Kong hedge fund industry has expanded rapidly. Results from our survey of hedge fund activities show that assets managed by SFC-licensed hedge fund managers or advisors rose almost ten-fold between 2004 and 2012, from about USD9 billion to USD87 billion. I believe appropriate regulation had an important role in this growth.

The way forward

Although regulators and regulation are a lot more palpable in your business today, there are limits on what regulation can achieve. Despite recent developments, the hedge fund industry remains relatively lightly regulated. And one reason for this is that the majority of you target professional and institutional investors. In many jurisdictions, this scopes you out of the regulators’ purview. Partly, it is also because regulations are inherently principles-based and higher level. There is often room for managers to determine how best to implement them. At the end of the day, it is you, the fund managers, who make the call on where you want to be on the governance spectrum.

Disclosure, I know, is a prickly issue for many of you. Many see it as a stark choice between either safeguarding proprietary trading models and positions, or greater transparency and more information for investors. I do not believe that such a zero sum result is the only outcome. We have seen numerous examples where fund managers are able to strike a balance between the two. What is needed is some hard, innovative thinking. It’s worth it.

Transparency is also in the best interest of fund managers. When the market is good, investors are generally happy to give managers a free reign and quietly watch their wealth grow. But markets are nothing if not fickle. At the first sign of weakness, investors will come pounding at the door asking for reassurance, with a string of probing questions. And you do have to be as truthful as you can without causing a panic. The last thing that a fund manager wants is to have investors mistaking legitimate fluctuations in returns as a sign of something shady going on.

Finance is built on trust. We all know the story of Arthur Andersen. A crisis of confidence triggered an exit of clients, precipitating a swift demise. Integrity, both actual and perceived, is central to the fund management business. I believe that on this issue, both regulators and industry participants are in complete agreement.

Another murmur of discontent that I often hear is related to the debate over the systemic relevance of the fund industry in general, and hedge funds in particular. The industry has been tireless in putting forth the argument that it did not cause the recent financial crisis, and that the uniqueness of the asset management industry necessitates special treatment.

Now, I agree that it is inappropriate to simply apply a prudential banking or insurance framework to the asset management industry. We as regulators need to clearly articulate what the key risks and concerns are, and agree on a broad solution. It is your responsibility, however, as hedge fund managers, to properly manage the risks that your individual funds face. The collective memory of Long Term Capital Management may have faded somewhat, but it still is a potent example a major of a hedge fund train wreck and how that wreaked havoc for the industry.

Finally, I would mention that risk management is no doubt a particularly relevant issue for many of you in the audience today. I believe many of you have established yourselves in Hong Kong to tap into opportunities in the Mainland. The Mainland has made great strides in its financial reforms and opening up, bringing a wealth of opportunities to Hong Kong. To Mainland authorities, however, the principle of risk management takes precedence over all else. If a major fallout or collapse of a fund takes place, it may delay or even cause a reversal of the reforms that all benefit from. This would be regrettable, not just to the hedge fund industry but also to Hong Kong and the Mainland. The market has a short memory but history always comes back to haunt.

Conclusion

The hedge fund community is characterized by innovation and the spirit of collaboration. These are the keys that drive success. I would add that putting investors' interest first is equally important. To this end, I believe that strong collaboration between the industry and regulators would help improve investment practices and maintain crucial investor trust and confidence.

With this, I wish you all a successful conference.

Thank you.