

The Regulation of Hedge Funds in Asia

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Keynote Address

Growing the Hong Kong Securities Markets: The Importance of Foreign Institutional Investment

by Andrew Sheng

Good morning, ladies and gentlemen,

On behalf of the Hong Kong Securities and Futures Commission, I would like to welcome you to this conference. This is the third in a series of three conferences organised by the Commission, the first two being on the important issues of corporate governance and equity research.

Today's theme is regulation of hedge funds. At a time when investors look everywhere for investments and hedging tools that most suit their needs, I think this topic is no less important than the other two.

My theme this morning is on the regulatory framework for hedge funds if they were offered for sale to the public in Hong Kong.

What are hedge funds?

Traditional unit trusts and mutual funds seek to reduce investor risks through diversification, and generally do not leverage or hedge their risks. Hedge funds are second generation investment funds, which are characterised by their diversity of strategies and use of investment instruments, although they do not always hedge their risks. They are specialist funds which engage in index or interest rate arbitrage, warrant

hedging, equity market neutral techniques, event driven, emerging market, equity long/short, convertible arbitrage, global macro and short bias investments. Because of their variety, it is difficult to define precisely what is a hedge fund. The Basle Committee for Bank Supervision has a definition instead of “highly leveraged institutions”, or HLIs.

It is estimated that the number of hedge funds has grown by more than 10 times in as many years to about 4,000 funds, managing some US\$400 billion. There is another estimated US\$100 billion in fund of funds. In Asia, there is an estimated US\$15 billion of hedge fund assets under management.

So far, hedge funds have been marketed mainly for the high net worth private equity class or institutional investors. The US SEC defines a high net worth individual as someone with a net worth wealth of US\$1.5 million. Institutional investors now account for roughly one-quarter of hedge fund assets.

The growth for hedge fund investments is driven by those who seek higher returns or some form of capital guarantee during a period of high volatility or market decline. For example, the CSFB/Tremont Hedge Fund Index returned 2.2% for the first nine months of this year, compared with a decline of other indices of between 18 to 39%. However, the promised higher returns are achieved with higher management fees, with managers taking typically 20% of any annual increase in value.

The hedge fund industry hit the headlines with the near collapse of LTCM in 1998, when there were calls for their increased regulation. After considerable debate, the international regulators have resorted to indirect regulation of the industry through the banking community, which provide most of counter-party and credit risk management of hedge funds. It was the highly leveraged nature of hedge funds that gave rise to systemic risks. Regulators do not worry too much if hedge fund managers and high net

worth individuals lose their shirts, but it is the exposure of the banking system and retail savings to speculative activity that is of concern.

But there is one further risk that regulators in smaller and less liquid markets are concerned about – the emergence of concentration risk, when hedge funds take large positions that threaten to destabilize the market as a whole. LTCM is probably best remembered as an example where even the most sophisticated regulators did not appreciate the systemic risks of non-monitoring of large positions. In 1998, the presence of “elephants in the pond”, where some market participants threaten to destabilize the markets, was one factor which no responsible authority could afford to ignore.

Fortunately, the degree of leverage of HLIs has now been constrained by the self-restraint of their major counterparties, the banks. These large banks and prime brokers provide an important market self-restraint on the industry. Moreover, the large macro-funds have scaled down their size and most hedge funds close their funds at around US\$500-\$1 billion, so that the larger number of players, with different techniques and market perspectives, enable a less concentrated market and therefore more level playing field.

These issues are complicated by the fact that hedge funds engage in very sophisticated techniques, the risks of which that are not well understood by investors, regulators or even some of the managers themselves. Such lack of transparency, with no clear regulatory oversight over the activities of the industry has resulted in a lack of communication between the industry and the regulators. As the key regulator of the Cayman Islands Monetary Authority said, the major jurisdiction where most of the hedge funds are registered, fund managers have to recognize that “in order for the industry to flourish, they had to seriously heed the lessons that came out of the

[LTCM] crisis such as the need for *greater transparency, investor awareness, enhanced risk management and openness to regulators.*¹

I am very pleased to have this opportunity to clarify any misconception that the SFC is biased against hedge funds. No, it is not.

No regulator should be biased against any class of investors. We only take regulatory action when there is market misconduct and matters which affect market integrity. We are concerned about the issues of transparency and level playing field, as well as the protection of investors. But we are also for market innovation, greater efficiency and liquidity for the market as a whole, and also choice for the investor. The matter is therefore to ensure that the fund management industry as whole, including hedge funds, work within a clear set of rules that are understood by the market participants and the investors.

Facilitate Growth of the Market

Let us not forget that one mission of the SFC is to support the continued development of Hong Kong as an international financial centre, ensuring markets are open, fair, efficient, and transparent.

As a common law jurisdiction, we allow all financial activities that are in full compliance with the law and regulations. This is achieved through the full due process of approval and conduct supervision of the intermediaries involved, and authorisation of products.

Hedge funds are being sold in Hong Kong by intermediaries to “private clients”. It is a fine point of legal interpretation whether these clients are members of the public, and as such, whether selling of the funds and other unauthorised products to them is unlawful.

¹ Mark-Anthony McKenzie, “Growth in the Global Hedge Fund Industry and Due Diligence of Offshore

The Commission welcomes the open dialogue we now have with some members of the industry and their prime brokers to have a better understanding of how the industry operates. We are delighted that some fund managers call for hedge fund activities to be brought within a proper regulatory framework, so that they may compete on a level playing field and without concern about inadvertently breaking the law.

The Commission does not intend to regulate the offering of investment funds to professional investors, as they arguably may take care of their own interests. Only offering to the public will be subject to regulation.

The safeguards and the protection of investors come from the rules of the game. As billed in the conference brochure, the SFC has been for some time working on criteria for the authorisation of hedge funds for offering to the public in Hong Kong. We will make sure the industry is engaged in the process, as in all important policy consideration.

I am therefore pleased to announce that a Consultation Paper on the Offering of Hedge Funds has been approved by the Commission and was released last week.

For the first time, we aim to publish comments that we receive on the SFC website (www.hksfc.org.hk). This is to ensure that the consultation process may be open to as much scrutiny and discussion as practicable. At the end of the consultation exercise, a consultation conclusions document will be issued to present the policy responses of the SFC to the comments and outline any necessary amendments to the proposals.

We are confident that the market as a whole will be more receptive to decisions made in this open and transparent manner, and these may

represent a rational balance of what will likely be diverse views of market participants and users, and the regulatory objectives of the proposals.

The SFC of course also welcomes comments from those who prefer not to have their identity or the details of their submissions published.

Our objective is that the “rules of the game” finally made will be clear, transparent and explicit in objectives. They should be able to promote market efficiency and a level playing field. They should offer an appropriate level of protection to investors, while at the same time giving due regard to regulatory burden on market participants. The rules must also be such that when they are breached, they can be effectively enforced in a transparent and accountable manner.

In short, the regulatory system should not be obstructive of changes and a stopper to innovation. The following explains why.

The Hong Kong Model

If Hong Kong’s financial market is to remain competitive well into the future, the regulators must reflect on whether existing regulatory processes meet their intended objectives. If necessary, a reform or some fine-tuning may be in order.

Investors nowadays have many choices and shun any market that fails in fulfilling its functions. What are the functions of the market? They are price discovery; resources allocation; *risk management*; and corporate governance. On risk management, I believe a complete and competitive financial market should offer a wide spectrum of financial instruments: stocks, bonds, futures, options, warrants, currencies, investment funds; and the list goes on. Inadequate risk management tools could lead to periodic bubbles, low credit spreads, high volatility, and poor returns on savings.

Hong Kong aims to become a financial product and risk management centre for the region. Institutional investment is the key to the growth of the Hong Kong market. While liquidity begets liquidity, institutional liquidity begets retail and institutional liquidity.

Recent international events have cast a pall of uncertainties. But the positive attributes in Hong Kong remain largely unchanged: assets for the Mandatory Provident Fund schemes are accumulating; the financial infrastructure is being enhanced to support development and trading of global products; and the securities legislation is being modernised. Hong Kong has a regulatory system that facilitates market development.

For example, in investment funds, the SFC is working on various guidelines to facilitate product innovation. A public consultation on authorisation guidelines for index funds has recently been concluded and the SFC is working on the conclusions and the final provisions. The Commission is also considering relaxing the regulatory framework for exchange-traded funds. In the coming year, there will be an overall review of the Hong Kong Code on Unit Trusts and Mutual Funds.

The Commission has been approached in the last few months by promoters to approve hedge funds. It is often said that hedge funds may generate non-market-correlated returns and help achieve a carefully balanced portfolio, and they should be popular when the market is in a “capital preservation” state, which many regards as now. The SFC keeps an open mind to the introduction of products that may meet the needs of investors. We have been told there is strong retail interest in Hong Kong. I think this is a judgement best left to be made by the business sector. While the degree of interest might to some extent influence the priority or urgency of the policy process, it does not change the fundamental consideration in the making of rules.

An Antithesis?

I would like to stress that authorisation of hedge funds is not a seal of recommendation to buy or not to buy.

I have said that we must have rules that are fair, transparent and promote a level playing field. The other most important aspect of our regulation is that investors must be allowed to evaluate the risks involved in investments. However, how much risk an investor is prepared to take is a decision for the investor. Invest with your eyes wide open as to the risks and returns.

But a piece of advice: investors must not throw caution in the wind when newly authorised hedge fund products come onto the market, no doubt with some suitable publicity. Retail investors, especially those with limited access to advice of independent financial advisers, must tread diligently.

They must ask themselves if they have a reasonable understanding of the investment strategies, risk profiles, volatility and returns of these specialised products. They must also ask, among other questions, if they are fully aware of the fees and charges.

It is therefore also important that in the proposed authorisation requirements, we ask the fund manager to ensure that its employees and all selling agents must possess adequate knowledge of the products so that they can explain the risks involved to an investor. We also propose that there must be steps to ensure the suitability of the investment for the investor. Comments are welcome on the proposal.

SFC will not countenance hypes. Investors must not be led to believe that hedge funds would invariably produce superior performance. The hedge fund market, at least as far as Hong Kong retail investors are concerned, is

in its infancy and investors should not rush into what may only be limited opportunities.

I wish to reiterate the importance of investor education and awareness to the healthy development of a market. This is going to be a joint effort by the Commission, the industry, and not the least, the media, whom I understand are listening in an adjacent room. The latest retail investors' survey of the Commission shows that about 90% of investors found investor education programmes through radio and newspaper articles useful. Nearly 80% wish to know more about investors' rights and responsibilities, and 69% wish to strengthen investment risks education.

The survey records a 9% retail participation rate in funds (excluding Mandatory Provident Fund schemes) compared with 22% in stocks. With increased education and awareness, as well as a wider range of products, a higher fund penetration is attainable.

It is primarily the responsibility of intermediaries to communicate the risks of a particular product to investors so they can make informed investment decisions. It will, however, also be necessary for the SFC and the industry to consider strategies for better educating the public on hedge funds generally.

We specifically encourage the industry to provide a glossary in their offering documents to explain the technical terms or any difficult concepts relating to hedge funds and the particular products.

The consultation paper outlines the rationale and details of the proposals. Andrew Procter will take you through them in a following session.

One will not fail to notice from reading the proposals that in a number of areas, such as investment restrictions and the timing for returning redemption proceeds, hedge funds are subject to more relaxed

requirements than the equivalents ordinarily for traditional unit trusts and mutual funds. This is to cater for the practicalities of the industry.

Conclusion

Despite their presence in the US for decades, hedge funds are a relatively new product to many members of the public in Hong Kong. Many have become acquainted with the term only because of the negativity associated with hedge funds during the Asian crisis.

The SFC clearly sees its responsibility to protect the interests of investors, small investors in particular. We must proceed prudently with the authorisation of hedge funds. But politics has no part in it, as some people might fear. The SFC merely seeks to conduct its business and regulate the financial markets firmly, fairly and efficiently.

The SFC is mindful not to stand in the way of market development. It is in Hong Kong's long term interest to increase the range of investment products that cater for the various risk management needs of investors.

I invite all of you to give your comments to the Consultation Document. Your views are not only welcome, but I promise they will help to shape the final set of rules of the game about offering hedge fund products to the public.

Thank you.

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