Hong Kong: Hedge Fund Hub of Asia – 2007 Conference

"Enhancing Hong Kong as a Hedge Fund Hub of Asia"

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Good morning ladies and gentlemen

1. I would like to thank AIMA for hosting this, the 5th Annual Hedge Fund Conference here in Hong Kong, and for bringing together this diverse group of fund management professionals and various market players of the industry. I hope this conference will serve as a platform for forging relationships and conceiving new opportunities for a healthy development of the hedge fund industry.

Robust growth of the hedge fund industry

2. Globally, hedge funds continue to be a popular investment. According to HedgeFund Intelligence, assets under management in global hedge funds have already increased to almost US$2.5 trillion as at the end of June. This represents a 19% growth during the first half of this year. About two-thirds of this increase had to be accounted for by net inflows of new money from investors.

3. China strategies have seen a significant growth, moving from US$6.5 billion to US$10.6 billion. In terms of location of fund managers, Asia ex-Japan strategies (in particular, China strategies) tend to mean that Hong Kong is a preferred choice.

4. This explains in part why Hong Kong has seen a robust growth in its hedge fund industry in these years. According to AsiaHedge, assets under management of hedge fund managers in Hong Kong increased from US$22.6 billion as of June 2006 to US$28.3 billion as of June 2007, representing an increase of 25% in just one year. Hong Kong was also ranked first in terms of number of new Asia-Pacific hedge funds launched in 2006 and the first half of 2007.

5. Many global hedge fund players have set up businesses in Hong Kong. The reasons that we are most frequently given for choosing Hong Kong in preference to other Asian jurisdictions include:
    - Hong Kong's geographical location in Asia and in relation to Japan, Europe and North America;
    - Access to greater levels of capital;
    - Access to superior professional support;
    - The availability of superior infrastructure; and
    - Hong Kong's proximity to China and the vast potential that it offers to investors.

Opportunities from Mainland China

Fast growing economy

6. Talking about China opportunities, Mainland China is currently the fastest growing economy in East Asia and the world. Between 1978 and 2006, Chinese real GDP grew from US$180 billion to US$2.68 trillion (based on 2006 prices). It is the fourth largest economy in the world after the US (US$13 trillion), Japan (US$4.4 trillion) and Germany (US$2.9 trillion). It is expected that China will surpass Germany and become the third largest economy shortly.

7. As of the end of September, there were 1,210 companies listed in the Hong Kong stock market, of which 19% were Mainland companies. The market capitalisation of these Mainland companies accounted for 53% of the total market capitalisation of the entire Hong Kong stock market. For the 12-month period ended 30 September 2007, 48% of the total market turnover was accounted for by these Mainland companies.

8. Since Year 2000, the value of Hang Seng China Enterprise Index has registered a significant increase by more than 8 times. The largest Mainland IPO (ICBC) was conducted in Hong Kong in 2006. We believe that Hong Kong will continue to serve as a major fund raising centre for Mainland companies, and more overseas investors will be attracted to participate in the Hong Kong stock market.

9. The opening up of the Mainland market through the QFII Scheme also presents an immense opportunity for the industry. To date, a total QFII quota of US$10 billion has been granted to foreign institutional investors, which may directly invest in the Mainland securities market. With a robust financial infrastructure and a large pool of professionals familiar with China "know how", Hong Kong continues to be an attractive platform for international players to invest in the Mainland.

Excess liquidity / Major capital exporter

10. Being the country with the largest foreign exchange reserves (US$1.4 trillion), China is poised to become a major capital exporter. The investment of US$3 billion by CIC (China Investment Corporation) in the Blackstone Group represented only 1.5% of its total expected capitalisation of US$200 billion. It is expected that more Mainland enterprises will be developing their international businesses and making direct investments overseas.

11. Under the QDII Scheme, approved banks, fund management companies/securities firms and insurance companies in the Mainland are allowed to invest in overseas capital markets. QDII funds flow to overseas markets through both equity investments and a variety of fund products. Since the implementation of the Scheme, a lot of bank QDII products have been developed, and many of them are linked to/invest in Hong Kong stocks and SFC-authorised funds.

12. Mentioning just banks and fund management companies alone, a total QDII quota of over US$36 billion has been granted by the China authority as of the end of November.

It is estimated that the utilisation rate of QDII quota is around 40% to 50%. The investment potential in this area, therefore, remains strong.

Mainland professionals

13. CEPA IV, for the first time, permits asset managers from the Mainland to set up subsidiaries in Hong Kong. The arrival of these Mainland professionals will make Hong Kong even stronger as an international asset management centre (with experienced managers from all major markets). The increased participation of Mainland fund managers will not only bring in PRC expertise including their knowledge about the PRC market and investor demands, it will also introduce connections and capital.

14. Hong Kong is well-placed to capture all these opportunities. To further enhance our competitiveness, we are also committed to providing a balanced and market-friendly regulatory environment, bearing in mind investors' interests.

Balanced regulatory approach

15. Nowadays, governments around the world are more concerned about the issues of positioning and competitiveness. Even the largest financial markets such as New York and London find it necessary to reassess their positions on this global stage.

16. Turning to Hong Kong, we (the SFC) clearly understand that our roles include not only regulation and enforcement, but also investor education and market facilitation. We see each of these roles as equally important.

17. Recognising the enormous growth of the hedge fund industry in these years and its significant impacts on the financial market and the economy as a whole, we have proactively engaged the industry such as AIMA and other market players/service providers to keep ourselves abreast of industry development and discuss with them issues of mutual interests. We take every opportunity to hear their feedback and suggestions, so as to enhance our services to the market, including intermediaries and investors being our key stakeholders.

Licensing of hedge fund managers

18. Let me quote an example. In May this year, we invited a group of Hong Kong lawyers and prime brokers to our office to clarify our licensing requirements in relation to hedge fund managers. We followed up this matter in June by formally issuing a circular, which is available for viewing on the SFC's website, concerning our general approach to the licensing of hedge fund managers.

19. In the circular, we make clear that firms already licensed or registered in the US or the UK as investment managers or advisers can expect to benefit from a streamlined licensing process in Hong Kong if they have good compliance records and they serve only professional investors. For firms that are not so licensed or registered, they can also benefit from the same streamlined process if they have proven track records.

20. Furthermore, because of the unique nature of the business conducted by hedge fund managers, we are flexible as to the experience (including overseas experience) that we will regard as relevant experience for the purposes of licensing. A broader range of industry experience such as asset management, proprietary trading, research, private equity, special situations and alternative investments, is regarded by us as industry experience directly relevant to hedge fund management.

21. Individuals nominated to be responsible officers of hedge fund managers, who fulfil the necessary criteria, can be exempted from taking the local regulatory examination.

22. In the circular, we also remind that under Hong Kong law, it is usually unnecessary for an overseas hedge fund manager to be licensed if its Hong Kong office is merely providing advice on securities and/or futures contracts to its holding company, the wholly owned subsidiaries of its holding company, the wholly owned subsidiaries of its holding company and its own wholly owned subsidiaries. Normally, a requirement to be licensed will not arise if research analysis and/or investment advice is merely provided to group companies (as opposed to external clients).

23. In relation to office space, we recognise that setting up and maintaining an office in Hong Kong can be expensive. We are, therefore, content to see hedge fund manages running their businesses in serviced offices, provided that they comply with our requirements on security, client privacy, etc.

24. We encourage potential licence applicants to meet with us before submitting their licence applications. By engaging in this dialogue, we find that we simplify the licensing process for applicants and that we tend to receive applications from them which fulfil all of our requirements. This, in turn, simplifies and accelerates our licensing process.

25. During the first three quarters of this year, 37 hedge fund licences were approved, exceeding last year's 29. Since June, we have noticed increasing numbers of overseas hedge fund managers visiting us to discuss their business plans and the licensing requirements, and our experience has been that reputable and experienced US and UK hedge fund managers receive our approval in 3 to 4 weeks after submitting their applications to us.

Retail hedge funds

26. Apart from licensing, it is worth noting that Hong Kong is one of the very first jurisdictions in the world allowing the sale of hedge funds to the retail public. In authorising retail hedge funds, the SFC adopts a multi-pronged approach to perform our role as gatekeeper:
    - First, we assess the acceptability of the hedge fund manager;
    - Secondly, we ensure adequate structural safeguards and proper disclosure in the fund set-up. We adopt a market segmentation approach via minimum subscription thresholds for different types of hedge funds;
    - Thirdly, we work with and encourage the industry to provide more investor education.

27. There are now 14 retail hedge funds authorised by the SFC with a total net asset value of about US$1.67 billion as at the end of September. Although the asset size of these retail hedge funds is relatively small compared to the entire hedge fund space, our framework tailored for retail hedge funds is another good example to demonstrate our effort to strive for a healthy market and product development while, at the same time, protecting investors.

28. We are pleased to note that major jurisdictions are moving towards the same direction as we did in allowing retail hedge funds, which have been made available for the choice of Hong Kong investors since 2002 after the issuance of our guidelines governing such products. This would not have happened if the SFC is not determined to do away with rules or norms that inhibit innovation and fair competition of the industry.

Cross-border regulatory cooperation

29. Given the global presence of hedge funds and their operators such as fund managers, prime brokers, administrators, we are fully aware that the SFC cannot simply work on its own. Therefore, we continue to build partnership with overseas regulators to deal with hedge fund related issues.

30. For example, at the international level, we are actively participating in the task force of IOSCO (International Organisation of Securities Commissions) to formulate key principles for the valuation of hedge fund portfolios and deal with other issues concerning retailisation of funds of hedge funds.

31. The IOSCO's Standing Committee on Investment Management (SC5) held its meeting on the 27th and 28th of November in Hong Kong. As part of the industry hearing in relation to regulatory issues concerning funds of hedge funds, we have arranged certain industry representatives who are conversant with the management of single hedge funds, funds of hedge funds and pension funds to offer their expert advice from different perspectives on the issues to the Committee. The session has proved to be a very fruitful exchange of ideas between the industry representatives and the regulators.

32. Last year, we conducted joint inspections with the US SEC on hedge fund managers licensed in both Hong Kong and the US, to review their infrastructure, corporate governance, risk controls, management of conflicts of interest, etc.

33. Last week, the US SEC conducted a seminar, namely "CCOutreach", at the SFC's office targeting chief compliance officers of US-registered investment advisers located in Asia Pacific. The seminar covered various regulatory topics including risk assessment, portfolio management, brokerage arrangements, trade allocations, soft dollars, performance advertising, etc. It was well received by about 40 senior compliance personnel from the region. Most of them were based in Hong Kong and some came from Singapore and Sydney.

34. Together with other regulators, the SFC is playing an active role and in the forefront to promote a regulatory framework that pays due regard to investors' interests, facilitates development of the market, and promulgates high standard of industry practices.

Business and investor-friendly tax system

35. I shall not end my speech without mentioning the Government's effort in implementing a business and investor-friendly tax system, which has further fostered Hong Kong's position as a premier fund management centre.

36. From March 2006 onwards, offshore funds are exempted from tax for profits derived from specified transactions in Hong Kong. Furthermore, the abolition of estate duty, which has been effective since February 2006, encourages people, including local and overseas investors, to hold assets in Hong Kong. More capital will be attracted to come here as a result.

Conclusions

37. The hedge fund industry is expected to grow further, as the demand for hedge funds by institutional and private investors remains strong. This part of the world (Asia and in particular, China) will continue to be a focal point given the immense investment potential.

38. The Chinese economy is growing fast. Whilst there is abundant capital and strong liquidity driving the Mainland markets, international investors continue to seek out value. Hong Kong's international characteristics and close connection with the Mainland enable it to serve as a bridge between the Mainland and the rest of the world. Using the Hong Kong platform, fund managers can better position themselves to tap into the China market and capital pool.

39. On top of that, we are committed to building a regulatory framework that is on a par with international standards and, at the same time, facilitates a healthy industry development. We will continue to work closely with the industry and other regulators to maintain Hong Kong as a leading hedge fund centre in Asia, attracting both capital and quality market players to come and stay. This remains a priority for us.

40. With that, I conclude this address and wish you all a fruitful conference today and a Merry Christmas and Prosperous New Year ahead. Thank you.