HKSI
Luncheon Speech by Mrs Alexa Lam
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Good afternoon. Thank you for inviting me to share some of my thoughts on a very current topic with all of you.

Introduction

When it comes to the issue of regulating hedge funds, there is bound to be enthusiastic debate. There are always questions about the risks hedge funds pose and whether they should be regulated and if so, how they should be regulated. Should hedge funds be offered to only private, high net worth, professional, institutional investors? Or should they be made available to retail investors?

There are no conclusive answers to these questions, as the market is always changing but I will touch on how we at the SFC approach the regulation of hedge funds in Hong Kong. Hopefully this will give you a better understanding of the issues involved.

Before we do that let's delve into some interesting real life case studies and see if there are any lessons we can learn from them. There's nothing like a big bang to start things off!

The devil and the deep blue sea

You may ask, "Are hedge funds really that dangerous?" According to a World Economic Forum (WEF) study, "surging oil prices, a pandemic or extreme weather are more likely to negatively impact the world's economic growth" than the collapse of a big hedge fund.

To put that sentiment to the test, Amaranth Advisors, a very large US hedge fund, imploded a few weeks ago and many expected its failure to shake financial markets around the world. Indeed, Amaranth's cash losses of about US$6 billion were significantly larger than the US$4 billion loss when LTCM collapsed in 1998.

An interesting fact of the melt down of Amaranth is that despite the size of the loss, it barely affected the financial markets. In the years post LTCM, many were dreading the collapse of another major hedge fund and the systemic impact that this would create and how it could reverberate through the world's financial markets. But this did not happen with Amaranth. Its collapse did not lead to any Armageddon in the financial markets around the world. In a matter of two weeks, the crisis was mostly over. As was noted in Fortune magazine, there were no emergency meetings by the US Federal Reserve or huge Wall Street institutions scrambling to devise a rescue package.

Proponents for less regulation of hedge funds could possibly hail this event as proof that the business is self healing. It has been reported that when Amaranth was melting down, bidding by other hedge funds for its loans and convertibles that were sold to cover its losses was so competitive that they were barely discounted.

One of the lessons learnt in the LTCM debacle

Post LTCM, regulators have been calling on counterparties includi imposed stringent requirements on the structure, fund managers' competence, performance fees disclosure, etc.

The authorised hedge fund market is very small, with total AUM of authorized hedge funds amounting to only US$1.48 billion as at the end of June 2006. Although this is a very small section of the hedge fund industry in Hong

Make timely risk aggregation of different types of risk exposures to hedge funds and be able to assess their overall concentration risk to the hedge fund sector as a whole; and

Develop appropriate risk analytics to better understand the linkages among different types of risks, and the likely interaction among market participants and across different but related markets under stressed conditions.

Concluding remarks

Finally, I would like to take this opportunity to say that we welcome quality hedge fund managers who have the proper risk parameters to set up in Hong Kong. We do recognize the role that hedge funds play in our market. They contribute to capital formation, promote market efficiency, and price discovery and add to market liquidity. Hedge funds also bring a wider investment choice for Hong Kong investors. And if they are properly used, they can help investors reduce their exposure to downside risks.

Hong Kong has a lot to offer to hedge funds, as it is the market with liquidity, openness, depth and access to the exciting Mainland market. In order to create a viable and thriving hedge fund industry, what is important is that we continue to work with hedge fund managers and the counterparties, creditors and investors of hedge funds to manage risks and develop the market.

Thank you.