KEYNOTE SPEECH AT LIPPER FUNDS AWARD 2008

"With the latest regulatory development and the industry AUM growing, how can the SFC provide an effective environment for the fund industry to grow successfully?"

By Mr Martin Wheatley

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Distinguished Guests, Ladies and Gentlemen, good afternoon,

It is my great pleasure to be invited to speak on this occasion, where the best performers of the fund industry for the past year are being recognised. Congratulations to all award winners for your hard work and outstanding performance. Please keep up your efforts - I hope you all can achieve good results again in what I suspect will be a very challenging year ahead.

2007 was another landmark year for the fund industry in Hong Kong - 257 new retail funds were authorised during the year. The number of SFC-authorised funds has just reached a record high of 2077 as at end-January 2008. According to the statistics compiled by the Hong Kong Investment Funds Association (HKIFA), fund sales reached record high in 2007 - the total subscriptions of retail funds amounted to US$45.5 billion by end-2007, representing a 87.1% growth over 2006.

The growth of Hong Kong's fund management business is due to many reasons. Among them, the close ties between Hong Kong and Mainland China, a large pool of professionals and robust financial structures. As a regulator, it is always a priority to facilitate the development of the fund industry in Hong Kong whilst, at the same time, maintaining strong standards. Today I would like to review what the SFC has done in 2007 in shaping our regulatory framework to facilitate the asset management industry, and outline some recent initiatives.

Facilitation of product development

It is essential for investors to have a range of investment choices which suit different investment needs. To facilitate product innovation, we adopt a disclosure-based approach in respect of a fund's investment strategy and fee structure as these features should be subject to commercial decisions. Fund managers are provided with the flexibility in the design of their products as long as they meet our basic structural and operational requirements.

a) First retail Islamic Fund in HK

In support of the Government's initiative to develop Islamic finance, the SFC has been working with industry participants to enable the introduction of Islamic products to the Hong Kong market. In November 2007, the SFC authorised the first retail Islamic fund in Hong Kong. Although this is a new product with some unique features (i.e. requirements imposed under Shariah law), we authorised this fund under our existing regulatory framework - to do this we required some additional disclosures in the offering document to explain the investment principles and features of the fund. Investor education materials specific to Islamic funds have also been issued to promote the understanding of the product by retail investors. We are very pleased to be able to have this fund brought to market under our regime, which we have always sought to administer fairly and with flexibility.

The fund has been well received by investors in Hong Kong, both retail and institutional. The fund raised more than US$20 million within 1 week after launch and the fund size grew to US$62 million by end-2007.

b) Growing interests in ETFs

We see growing interest in fund houses in launching more ETFs in HK. Last year, we authorised 8 new ETFs including an ETF which tracks a commodities futures index. The new commodities futures ETF provides retail investors better access to the commodities markets - historically a predominantly institutional market. By listing on the stock exchange, the commodity futures ETF can easily be traded by retail investors like a listed stock.

To date, there are 17 SFC-authorised ETFs with market capitalisation of about US$12 billion. Comparing to other Asian markets where the ETFs listed are mainly domestic equity plays, we have a great variety of ETFs offering exposure to different markets and different assets. Our ETF market has been the largest in Asia ex-Japan in terms of both market value and turnover and has recorded a significant growth as at end-2007. The average daily turnover of Hong Kong ETFs in 2007 was more than double the value in 2006 and was six times higher than that in 2005. This reflects the growing popularity and the strong liquidity of the Hong Kong ETF products.

c) UCITS III funds

The SFC has continued to facilitate the processing of UCITS III fund applications by issuing further streamlined measures for UCITS III funds with special product features and specialised schemes, e.g. index funds and guaranteed funds. Last year, we authorised the first retail 130/30 UCITS III fund in Hong Kong. A 130/30 fund employs a long/short strategy and may take long positions up to 130% of the fund's net asset value and short positions up to 30%. We also authorised the first UCITS III fund which may seek a significant exposure to the performance of hedge fund indices. The SFC will continue to monitor the latest developments in the UCITS III regulatory framework and review our measures as necessary.

Market facilitation

To maintain the competitiveness of our fund management industry, we need to constantly review the related policies by reference to the views of the stake-holders and practices in other countries. Last year, we introduced a number of new measures in our licensing and product authorisation process.

a) Streamlining of licensing of hedge fund managers

Now as you know, the regulatory structure we operate in Hong Kong requires fund managers to be licensed and to have two Responsible Officers. Responsible Officers must satisfy us as to their qualifications and experience and, in the case of fund managers, this generally requires them either to pass a local regulatory framework examination or to be exempted if their experience warrants this. We have always been prepared to grant such exemptions, but it seems that this was not always known to fund managers and their advisors. Indeed, we got complaints from some of the hedge fund advisors – the lawyers and prime brokers – that our requirements (including our perceived insistence upon Responsible Officers sitting the local regulatory framework examination) were making it costly and time consuming for new entrants to set up.

So we made a few changes, starting with an education campaign (initially aimed at the lawyers and prime brokers!) designed to make our requirements better known to them and to their fund manager clients. This included a reminder that intended Responsible Officers may seek exemption from our examination requirements. In June last year, we issued a circular drawing together and clarifying our requirements in relation to the licensing of fund managers. Basically, we adopted a pragmatic approach by allowing a more flexible interpretation of "relevant industry experience" – having regard to the unique nature of hedge fund managers' operations. For firms already licensed or registered in the US or the UK as investment managers or advisers, they can 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. And to cater for those situations in which our examination requirements cannot be escaped, we also asked HKSI to look at the exams – not to make them easier I hasten to add – but to refresh them and make them more relevant.

Such clarification of our requirements and streamlining of the licensing process was very well-received by the market. In 2007, there was a 62% increase in the number of licence applications received by the SFC from hedge fund managers and a 72% increase in approvals over the previous year.

b) Added flexibility in delegation of investment management functions to affiliates

In October 2007, the SFC has introduced greater flexibility for managers of authorised funds to delegate their investment management functions overseas. We did this because of the globalisation of fund management firms and the growing trend for fund houses to set up local affiliates close to the markets in which they invest. Prior to this initiative, the investment management operations would generally be based in Hong Kong or an Acceptable Inspection Regime ("AIR"), where there are similar standards. The new approach has allowed managers of authorised funds to delegate their investment management functions more broadly.

The arrangement opened the door for asset management experts that are most familiar with the local markets all over the world to provide investment management services to the HK authorised funds. We have already authorised various funds with non-AIR delegation in jurisdictions such as Belgium, Japan, Netherlands, Singapore and Switzerland etc. International fund houses as well as local investors will benefit from the greater flexibility in this enhanced approach.

c) Proposal to streamline review of marketing materials & notices

Last year, we authorised about 8,000 marketing materials of our authorised products. Every tram carrying an advert, every bus stop carries an ad approved by us. Now this seems odd that in a professional industry such as ours, we have to do spell checks for you – not the people represented here today I hasten to add. We do it in part because the SFO requires it and in part because our Code does.

In fact, we have recently issued a consultation paper on streamlining pre-vetting of ads. The proposed changes include shifting the SFC's focus from pre-vetting towards post-vetting and monitoring so far as the law permits, and to harmonise the requirements applicable to the advertisement of schemes under the different product codes administered by the SFC. For most products, having us in the approval chain simply adds another stage in the process of getting a product to market. So our suggestion is – you do it. But please do it properly. The consultation on the proposal has just ended and we are now reviewing comments received.

The accomplishment of the consultation exercise reflects our successful partnership with the industry. In formulating the proposal, we have been working closely with the industry and consulted widely on the drafting of the revised advertising guidelines. Thanks to those who have contributed their ideas to us and we look forward to your continued support to the Commission.

PRC initiatives

Last year, the major breakthrough for the industry was the implementation of the Mainland QDII scheme which presents an immense opportunity for industry participants in both the Mainland and Hong Kong to develop new business opportunities. So far, a total of around US$53 billion QDII quota has been granted by SAFE to commercial banks, fund management companies, securities firm, and also insurance companies. The products under the QDII scheme can invest in securities and retail funds offered in Hong Kong. The QDII scheme not only provides capital influx and liquidity from the Mainland, it has also attracted a variety of funds seeking to be authorised in HK.

In addition to this product growth, we also expect mainland fund management companies to set up operations in Hong Kong, under CEPA IV. We believe that CEPA IV will bring more Mainland fund management companies to establish their operations in Hong Kong. This will not only enable Mainland fund houses to widen the scope of their activities, but also increase the size of the fund management industry in HK. Equally importantly, our industry player will gain hands-on experience in dealing with Mainland investment rules and regulations, as well as serving the investment needs of the Mainland. I believe this is fundamental to our success in playing a valuable role in the development of asset management business in China. The SFC will continue to work closely with the Mainland regulators in respect of the development of QDII, CEPA IV and other future initiatives.

Regular and close dialogue with overseas regulators

Due to globalisation of the market and HK's open door policy, we are not immune from market turmoil in other countries. For instance, the lesson learnt from the US subprime issue is that regulators are faced with increasing challenges in view of the complexity and novelty of investment tools being used by mutual funds and also the contagion effect from derivative products. We work closely with other regulators in monitoring the situations and dealing with common challenges.

Investor Education

With more and more innovative products coming in the retail funds market, we reckon that having an educated mass of investors, who are fully aware of the investing decisions they are making, is as important as getting the codes and guidelines being adhered to. Last year, we initiated various investor education campaigns to promote investors' understanding in the new products authorised by the SFC, e.g. issuance of articles and FAQs relating to ETF tracking commodities index, Islamic funds, 130/30 funds etc. We have been working closely with the industry on investor education front – we believe the industry should also take on the responsibility to inform and educate retail investors on the special/unique features of their funds and the related risks, either by way of disclosure in the fund prospectus, marketing materials or FAQs to investors.

Concluding remarks

Looking forward, competition is expected to be stiffer than ever and the market will be more volatile this year. In such challenging period, we need to continue attracting quality market participants and investors, which will in turn facilitate the growth of the overall market. As a securities regulator, the SFC needs to keep reviewing our rules and regulations to remove any obsolete requirements and to enhance our regime to ensure that our regulatory standards are in line with internationally recognised standards. We will also continue to work in partnership with you on market facilitation bearing in mind interests of investors. We look to your continued support to the SFC.

Once again, I wish to congratulate the award winners for your well-recognised achievements and your hard work in the past year.

Thank you.