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Keynote address at the Structured Products Asia Conference
"Hong Kong – a hotbed for ETF growth?"

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Today's conference devotes an entire stream to exchange-traded funds (ETFs) and indices, so I want to spend a little time this morning focusing on this market. Some of the broader regulatory considerations I will touch on, however, are also relevant to structured products and those of you who are involved in designing, arranging or distributing these products to the retail market in Hong Kong.

Ascendance of ETFs in Asia

As we have said before, we are committed to enhancing the ETF platform in Hong Kong. We believe that it's an area in which we have a position of strength in Asia, and which presents both product providers and investors with opportunities.

As of August 2009, Hong Kong was the second-largest market in Asia for exchange-traded funds. This was both in terms of turnover (where it ranked second to the Mainland) and in terms of aggregate market capitalisation of ETFs (where it ranked second to Japan). August 2009 turnover for ETFs as a percentage of total turnover on the Stock Exchange of Hong Kong was 4.5%. By way of comparison, this figure was in the realm of 11% for comparable trading on the New York Stock Exchange and NASDAQ. I might note here that the ETF market in the United States, although established much earlier, began to develop in earnest fairly recently, around 2005.

The financial markets were battered in 2008, and the fund management business in Hong Kong was no exception. Combined fund management business in Hong Kong (including REITs) had dropped 39.3% by the end of 2008 compared with a year earlier. But on a trailing three-year average basis, the combined fund management business remained in an uptrend. And the international nature of the combined fund management business remained intact. For the non-REIT fund management business, the proportion of funds sourced from non-Hong Kong investors remained steady at about 64%. This is indicative of Hong Kong's ability to attract capital for management, and also of the capabilities of our intermediaries, and that includes many of you here.

The huge setback in the markets last year has forced a rethink on many fronts. Investors are demanding further transparency and efficiency, liquidity and better risk management in investment products. We believe that these factors may provide tailwinds or impetus for ETFs to gain critical mass, in or through the Hong Kong market. Of course, we do not see this as needing to be at the expense of other market segments. Our asset management segment has had stellar performance year after year, and traditional fund management is always a key portion of investment portfolios.

As you will no doubt discuss in much more detail in later sessions today, ETFs can offer some attractive features. ETFs can be traded throughout market sessions like stocks and typically have lower management fees than actively-managed funds, although investors do pay sales commissions and charges for trades. ETFs offer diversification and transparency, although this will depend of course on what a fund tracks, how broadly it is based and on how it effects its strategy. ETFs can also offer exposure to asset classes, sectors, industries, countries and regions which an investor may not easily be able to replicate.

I anticipate further growth and innovation in the ETF market. ETFs are clearly gaining popularity in Asia. I note that assets under management for ETFs in Korea increased substantially (in the realm of 40%) between 2007 and 2008, and the number of ETFs in Japan stood at 79 at the end of August 2009, up from less than 20 at the end of 2007. On the Mainland, where the first ETF product was introduced in early 2005, the ETF market is now ranked first in Asia in terms of trading volume.

Hong Kong's own ETF story

The ETF market in Hong Kong has come a long way since the Tracker Fund of Hong Kong was authorized in late 1999. As some of you may recall, the Tracker Fund was established for purposes of the orderly disposal of the equity positions acquired by the government during the 1997-98 financial turmoil in Asia, and was the first of its kind to be authorized by the Commission. While the fund's structure and offering mechanism differed from those of funds commonly authorized by the Commission at that time, the general applicable principles remained the same. The initial public offering of that fund was then the largest in Asia ex-Japan, and today the Tracker Fund is still the largest ETF in Hong Kong in terms of market capitalisation.

We saw the first ETF tracking the China A-share market (the iShares FTSE / Xinhua A50 China Tracker) in 2004. This was the first ETF in the world to offer investors outside the Mainland access to the A-share market in China. Again the fund's structure differed from those commonly authorized by us but, working in the belief that the product would give investors a wider choice of markets, we were able to authorize it. We saw our first bond ETF in 2005, the first local ETF tracking the performance of a foreign stock market (in this case the BSE SENSEX) in 2006, our first commodity futures ETF in 2007 and our first gold bullion ETF last year.

As of the end of September 2009, there were 37 SFC-authorized ETFs traded on the Stock Exchange of Hong Kong, with a total market capitalisation (excluding the gold ETF) of USD20.89 billion (a very modest 1.1%) of total market capitalisation of all companies listed on the Stock Exchange). In the last year, the number of ETFs has increased by 54%, and the aggregate market capitalisation has increased by 50%. We have ETFs with geographical exposure to Hong Kong, the Mainland, Japan, Korea, Russia, India, Taiwan and emerging markets generally. We have ETFs tracking equities, bonds, gold, currencies and a commodity index.

Let us look at a little regulatory history. The Commission published guidelines on ETFs in late 2003. These streamlined requirements for passively-managed index-tracking ETFs and granted relief from certain requirements in the Code on Unit Trusts and Mutual Funds in light of the relatively simple investment objectives and strategies of these funds and their greater degree of transparency. The removal of these constraints was aimed at facilitating the development of a regional ETF market in Hong Kong within an appropriate regulatory framework and thereby providing wider choices for investors. The Listing Rules for the Main Board of the Stock Exchange of Hong Kong were also revised in 2003 to streamline requirements for listing and trading of units in collective investment schemes (including REITs) authorized by the Commission. More recently, as the market has developed further, we extended levy exemptions to all Stock Exchange of Hong Kong market makers, allowing them to provide better prices to investors, and we granted corporate-form ETFs exemptions from the disclosure-of-interests requirements and certain share registrar requirements in order to provide a level playing field for listing of ETFs in Hong Kong regardless of their legal form.

We continue to seek opportunities to broaden and deepen our markets and provide opportunities for market participants and wider choices for investors. The ETF market is no exception.

Major breakthrough for the Hong Kong ETF market – building externality with Taiwan

Earlier this year we exchanged with the Taiwan Financial Supervisory Commission a Side Letter to our 1996 bilateral Memorandum of Understanding to provide for mutual recognition and opportunities for cross-listing of ETFs. Three Hong Kong ETFs were successfully listed on the Taiwan Stock Exchange in mid-August. The first Taiwan ETF listed on the Stock Exchange of Hong Kong on 19 August 2009. Additionally, the China Securities Regulatory Commission has agreed to include as a CEPA VI initiative the prospect of listing Hong Kong equity ETFs on Mainland exchanges.

The landmark cross-listings in the Taiwan market are a historic step forward in the financial co-operation between Hong Kong and Taiwan. More importantly, they represent further progress in linking up the markets in the Mainland, Hong Kong and Taiwan, with Hong Kong serving as the gateway.

Mainland opportunities abound

The significance of these links, both to the markets of Hong Kong, the Mainland and Taiwan, and investors interested in these markets, cannot be understated. At the moment we have listed in Hong Kong three ETFs tracking the A-share market. Together, they constituted 82% of the total turnover of the Hong Kong ETF market in September 2009. The A50's daily turnover in September amounted to 75% of the average daily turnover for all ETFs in Hong Kong. Since their launch in mid-August, the three Hong Kong ETFs cross-listed in Taiwan have together contributed to a large proportion of the Taiwan ETF turnover, both in terms of volume and value. For those who are statistically-minded, the figures I have are 38% of the volume turnover and 25% of the value turnover, for the period from launch until the end of September 2009, with the W.I.S.E. CSI 300 China Tracker accounting for the lion's share of this. In fact, this fund ranked second in terms of daily average turnover in the Taiwan ETF market in September 2009, and has ranked first on several days since its launch in terms of unit turnover.

These all point to the huge interest outside investors from all corners of the world have in the Mainland A-share market. And it is to the credit of our market, and our financial intermediaries, that we have captured the opportunity to serve these interests. It is befitting that it is in Hong Kong, the offshore financial market of China, that we have created products that give investors exposures to the A-share market while the A-share market remains closed to them. Thus far, we have prudently managed the risks. Trading is orderly. As the A-share market continues to experiment with opening up to the rest of the world, the behaviour and patterns, and risk management models, in the three Hong Kong listed A-share ETFs could provide some useful pointers.

That is the incoming side of the balance sheet. Let us now have a look at the outgoing column. While the amount of Mainland assets managed in Hong Kong was relatively small (HKD64 billion in 2008), we expect that this will increase in the years to come. According to estimates, by the end of May 2009, the State Administration of Foreign Exchange had granted a total investment quota of USD40 billion to 10 Mainland fund management enterprises and one securities firm, and a USD16.6 billion quota to 21 Mainland commercial banks to invest in overseas markets pursuant to the Qualified Domestic Institutional Investor (QDII) program. As of the end of May, the largest group of QDII investors, Mainland insurance companies, held total assets in the realm of RMB3.6 trillion. Under provisional rules issued by the China Insurance Regulatory Commission, these institutions may invest as much as 15% of their assets in overseas markets. As you all know, we were the first outside market that the Mainland commercial bank QDII invested. Today Hong Kong remains a key portal for Mainland funds investing overseas.

Building bigger critical mass and externalities

We are extremely encouraged by the success of our cross-listing efforts with Taiwan. We believe the success of our market lies in our ability to attract critical mass, and the strength and extent of our market's externalities. To build critical mass, we will encourage more issuers to come to Hong Kong to offer their products. We will provide a conducive environment for home grown issuers and products. We will build a regulatory platform that gives each player room to grow. And we will develop externalities with other markets whose regulatory standards are broadly comparable to ours, to allow cross-listings of ETFs, and other products. I believe that of the universe of 37 ETFs listed in Hong Kong, at least some, and not just the A-share ETFs, will be of interest to investors in some of the other outside markets. As we build better and more extensive externalities, investors benefit.

Regulatory principles governing ETFs

Our philosophy is very simple. We believe that Hong Kong's interests are best served by its open-architecture approach to product offerings. We believe that investors should be able to make their own choices from a broad range of investment products. It is, however, important to strike the right balance between facilitating market development and providing an appropriate level of protection for investors' interests. I would therefore like to spend a few minutes looking at some of the regulatory considerations relevant to different types of ETFs. Some of these issues are not confined to ETFs and may arise in the case of other types of funds and in the case of structured products as well.

Hong Kong's regulatory regime for offers of investment products is disclosure-based. The general standards and specific requirements for disclosure of information about products are supported by rules and regulations governing conduct of intermediaries and by investor education initiatives, and backed up by strong and effective enforcement action against those who fail to fulfil their obligations.

ETFs can vary widely in terms of the exposures they offer, their strategies, and the investor time horizons for which they are designed. Some are plain vanilla; others represent specific and often quite powerful tools for more sophisticated investors. Naturally, the investment risks posed by ETFs vary accordingly. We are seeing continued innovation in the market. Some ETFs have features or adopt structures which raise further points for consideration.

Rather than holding the index constituents or assembling an underlying portfolio, an ETF might use partial replication, seeking to track rather than replicate an index. Or an ETF might gain exposure to an index by using swaps or combinations of derivative instruments. This, in turn, raises additional issues of counterparty risks and transparency in the type of collateral held, how it is held and how it is managed. In recent months, we have been working closely with some ETF issuers who use financial derivative instruments to replicate the indices they track to mitigate counterparty risk exposures and address concerns that have recently arisen as a result of the market turmoil.

The potential for conflicts of interest is another important matter. Conflicts, or potential conflicts, may arise in a number of situations. In the scenario I just described, for example, where a fund uses synthetic rather than physical replication of an index, the fund might seek to enter into derivative agreements with a related counterparty. Or we may see an ETF seeking to track a proprietary index where the index sponsor and the fund manager may be affiliates. Conflicts of interest should be avoided wherever possible. If it is not possible to avoid a particular conflict of interest and if investors' interests can be appropriately safeguarded, it may be sufficient for the conflict to be managed and minimised. This will depend, however, on the nature of the conflict and the measures adopted. And full disclosure must of course be made to investors.

A further example is the advent of leveraged and inverse ETFs in various markets around the world. These are not intended as long-term investment products. We have seen commentary about the nature of these ETFs and how important it is for investors to truly understand their objectives. We have even seen statements issued by regulators cautioning investors to have regard to the purposes for which these ETFs are designed before deciding whether to invest. In areas such as these, sufficient product disclosure and suitability assessments on the part of intermediaries are clearly crucial, and need to be supported by investor education to give investors the necessary tools to make their investment decisions.

These issues, of sufficient disclosure, of investor education, of transparency and of the mitigation of risks inherent in the structure of a product, are not unique to ETFs, of course. For many of you involved in the structured products or structured funds areas, particularly where products are offered to the public in Hong Kong, these matters will be equally applicable.

The SFC public consultation on investor protection matters

I'm sure most of you know that we recently released a consultation paper on investor protection matters, which addressed not just sales practices but also requirements for funds, investment-linked assurance schemes and structured products which are intended to be offered to the public in Hong Kong. This included a new structured products code. Although structured products are different animals and raise some unique considerations, the new structured products code draws in places upon some principles in the Code on Unit Trusts and Mutual Funds. Examples are the risk management and conflicts of interest points which I mentioned earlier, provision of liquidity (in this case by way of market-making in the relevant product), and areas such as limitations on types of collateral and eligibility requirements for trustees/custodians, where applicable. I am sure most of you have either seen this consultation paper or been briefed on it by your advisers. It's available on the Commission's website and I encourage those of you who are interested parties to provide your comments and feedback on the proposals contained in it.

We look forward to continuing to work with you in capitalising on Hong Kong's position and developing its financial markets. We look forward to hearing your views on the formal consultation. We also encourage product providers, issuers, asset managers and arrangers to approach us at an early stage to discuss their plans for new products, particularly where they possess novel features. Our doors are always open and we are just a phone call away.

Thank you.