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SFC
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Keynote speech at Lipper Fund Awards 2009

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Introduction

Good afternoon distinguished guests, ladies and gentlemen.

I would like to thank the organisers of the Lipper Fund Awards for inviting me to speak at this important event.

Let me first congratulate all the award winners today. These are extraordinary times, and it calls for exceptional qualities to fare better than the rest. 2008 was an extremely challenging year for the financial markets. I strongly believe that it is in difficult times that the crème rises to the top and for those of you who did well last year, you have either displayed rare skill in finding that elusive alpha or else you were very, very lucky. Or maybe it was a winning combination of both! If so, you have both talent and blessings, which steered you away from the beta decimation last year.

The Hong Kong fund industry has suffered from the turmoil but is holding up relatively well

The financial storm has swept the shores of the world's markets. We all know the score. Last year, the Dow recorded a 34% decline, the FTSE 100 was down by 32%, the Japan Nikkei had a 42% drop, and the Hang Seng dropped by 48%. The emerging markets have fared much worse: Russia was down 72.4%, Poland dropped 51.1% and Vietnam lost 66%. We are now into 2009 and the storm continues unabated. This has no doubt caused a severe drain on your Assets Under Management (AUM). According to figures from the Hong Kong Investment Funds Association (HKIFA), total retail sales net of redemptions turned from a positive US$117.63 million at the beginning of last year to a negative US$573.2 million by the end of 2008. This translates to a staggering 587.3% decline.

It has not been all gloom and doom though. So far, the fund industry in Hong Kong has been resilient. The number of firms licensed for asset management in Hong Kong grew by no less than 17% between end 2007 and end 2008. Over 100 new asset management firms were licensed and an additional 17 licensed firms added asset management to their licensed activities during 2008. Furthermore, the number of authorised unit trusts and mutual funds actually experienced a mild growth of 6.3% year-on-year between January 2008 and January 2009. For the first time, the trading volume of our ETFs surpassed Japan's in 2008, putting us in the Number One spot in Asia.

The fund industry's value-added service to investors
– Assessment and management of risks

It is important to highlight that despite serious market retrenchments and significant redemptions, SFC-authorised funds continue to operate smoothly. Of the 2,279 authorised funds, all but three have continued to allow trading and redemptions. The three who suspended redemptions invested in emerging market bonds and ran into liquidity problems. Although the markets have been extremely volatile, investment values have dropped substantially, and redemption volumes have shot up, there has been no disorder or panic among our fund investors. To me, this is a positive reflection of the confidence that investors have, not only in the fund industry but also the regulatory framework under which the fund industry operates. This confidence is based on the trust that investors generally have in their fund managers' professional experience and honesty. In many ways, investors' trust is the most valuable commodity of all.

Those investors who invest in SFC-authorised funds look to the fund managers to put their money to work by capturing opportunities and avoiding pitfalls. Investors expect that fund managers will do a far better job than investors themselves. In turn, fund managers are governed by the fiduciary duties imposed by the regulatory framework that sets and enforces the rules of the game. Your value to investors is your ability to analyse markets not only from top down and bottom up but just as importantly, from the different correlations among sectors, markets, asset classes and the impact of economic, social, political and other events on these assessments.

Let me illustrate what I mean. Over the last couple of months, we have been in close contact with fund managers over the developments in the US auto industry. Needless to say, those managers whose portfolios have exposures to the large players in that industry have been monitoring their exposure. But it is not just the direct exposure to car manufacturers per se that you are watching. You are probably also assessing the indirect impact and other knock-on effects that the failure of a major car maker could bring about, and how these might adversely impact your portfolio, and possibly provide unique opportunities. You may have assessed the impact on auto makers' counterparties such as suppliers, lenders and others in credit chains having a connection with these auto makers such as credit default swap (CDS) issuers and holders of credit-linked instruments. You may have also considered the likely implications of such an event on the values of corporate bonds overall and the wider effect on credit and its effect on other sectors of the economy, both in the US and other countries.

While you continue to adjust the composition of your portfolio against these considerations, you should also keep an eye on the financial health of your fund's own counterparties who may be adversely affected by the fallout. This includes, for instance, any swap or other derivative counterparties to your fund. In parallel and just as importantly, you should be satisfied that your fund's trustee has properly performed its asset segregation duties, and that you have adequate liquidity to meet a larger than normal amount of redemptions. In short, stress-testing, monitoring of liquidity, surveillance of exorbitant market movements and consistent marked-to-market valuation are key tools that you must deploy at all times and especially in the current volatile market environment.

I am sure you are all aware that previous assumptions or modelling based on data and information collected in the last 10 years of bull market may require fresh validation. Since past performance is not a reliable indicator of future performance, you should always be careful about over-reliance on back-testing analysis.

Some trends in the funds sector

Let me now share with you some of the trends regarding new funds that we are beginning to see in the market. Although SFC-authorised funds have generally held up well so far, many of you tell me that in the last five months it has been difficult selling even our authorised funds. I have also noticed that the number of new funds coming in for authorisation has dropped during this period as compared to the same period in 2007. Between 1 September 2008 and 28 February 2009, the SFC received 115 new fund applications, compared to 306 for the same period last year, i.e. dropped by 62%.

While many of the new applications that come in are of the plain vanilla type, we have noticed that some of them have structures that may need to be more carefully thought through by the industry, particularly from the perspective of long-term sustainability of the fund management industry.

These applications are for UCITS III funds, which have been authorised or are at the same time seeking authorisation by their home regulator in an EU member state. UCITS is a popular retail fund product that enjoys strong branding on a global scale. In Asia, UCITS funds are very popular in Singapore, Taiwan and Hong Kong. Of the 2,279 retail funds authorised by us in Hong Kong, around 72% (1,637 funds) are UCITS funds domiciled in European countries, predominantly Luxembourg, Ireland and the UK.

A key reason for its popularity has been that UCITS funds offer investors an opportunity to invest in an offshore fund which is regulated by its home regulator (who is an EU member state) and adheres to a set of common principles promulgated by the EU regulators. It also has the benefit of a long track record of compliance with a robust regulatory framework that has evolved with the development of the market.

With the launch of the UCITs III platform since 2002, however, fund managers are no longer confined to a set of simple investment restrictions. UCITs III funds that have adopted the “expanded powers” provisions may directly invest in structured financial derivatives and not just for hedging purposes. This flexibility, coupled with the rapid progress in financial innovation, has contributed to a new breed of funds under the UCITS III framework which can effectively operate under hedge fund-like parameters.

A week ago, the Financial Times carried an article about “a march of hedge funds towards UCITS”. Briefly, the article reported that some large fund groups are taking advantage of the expanded powers under the new UCITS rules to apply aggressive hedge fund strategies and esoteric instruments that are not traditionally found in UCITS funds. According to the article, because of the sharp decline in hedge fund business, hedge fund managers are now looking to explore the UCITS retail space.

We have seen UCITS III funds wrapping within itself structured investments in the form of bespoke swaps, repos and proprietary indices (often backed by a pool of collateral) in order to achieve "alpha" for investors. It is not uncommon that in these structured funds, the swap counterparty, index sponsor, value calculation agent and the fund manager all belong to the same financial or banking group.

Our regulatory philosophy recognises that there are different funds for different investors, and it is not for the regulator to decide for investors as to whether a particular fund is a good investment for them. Investors should be free to make that decision based on the strength of the advice given by the intermediary on the suitability of the fund, after considering the investor's investment needs and personal circumstances. However, because investors are giving fund managers of SFC-authorised funds a discretionary management mandate, it is incumbent upon our fund managers to ensure that the funds they offer have in place structural fairness and controls to deal with concentration risk regarding counterparty, conflicts of interest, valuation and liquidity. Let me now discuss these briefly.

Concentration risk regarding counterparties

Fund investors expect a reasonable level of diversification of risks. Where a fund invests in a swap and the swap counterparty and fund manager are the same legal entity, it is difficult to see how this business model meets investors' expectation of risk diversification.

Conflicts of interest

In the case of a structured fund, when it is managed and operated by entities within the same group, or in more extreme cases, different operating arms within the same entity, it brings the issue of conflicts of interest into sharp relief.

When a fund manager enters into a swap with a single counterparty within the same group, the fund manager could be caught in a dilemma – the duty to rigorously pursue the rights of the fund against the swap counterparty invariably conflicts with the interest of the group of which the manager is a member. Needless to say the dilemma is most acute if the manager and the swap counterparty are parts of the same entity. No doubt the manager should make clear and upfront disclosure of this conflict in the fund documents. The question, however, is whether any kind of disclosure could put investors at ease regarding such a fundamental and seemingly irreconcilable issue.

Valuation

Fair and transparent valuation is key to the protection of investors' interest. Where a fund has wrapped into it bespoke contracts e.g. swap, repo or an exposure to a proprietary index, it is important that the key parties in the structure are independent. The fund manager should ensure, at a minimum, that valuation of the swap and the underlying collateral is done by an independent agent using objective criteria and processes and that this process is subject to independent oversight.

As I mentioned earlier, we have seen applications where the valuation agent, the swap counterparty and the fund manager all belong to the same group. This leaves open the question of whether there are sufficiently effective measures available to a fund manager for it to mitigate the risk of subjectivity and the perception of possible bias when the various components of a structured fund is valued.

Liquidity

Closely correlated to the point regarding diversification and valuation is the issue of "liquidity" of the assets of a retail fund. The repo, swap or exposure in a proprietary index is highly customised to suit the specific needs of a fund and this gives rise to the immediate question of whether this type of investment could be unwound promptly to meet any sudden redemption spikes, particularly when the market is facing a credit or confidence crunch. The fundamental question here is, does a highly structured fund using bespoke instruments, for which there is arguably no market, meet the needs of investors of retail funds?

I am aware that under the UCITS III platform, funds may be structured in the way I have just described. This is an area that we would like our fund managers to think about, and to come in to discuss with us. As you know, the Code on Unit Trusts and Mutual Funds (UT Code) requires structural safeguards to be imposed on SFC-authorised funds. The rationale for this is simple. Because fund managers have been entrusted to manage monies that belong, in most part, to the average man on the street, it is only fair that these managers operate under certain minimal structural safeguards to protect that trust.

Closer working relationship between regulator and industry

Over the last five months, many of you have approached us to talk about market issues and difficulties. I happily notice that your eyes light up and your faces are animated as you describe the outlines of a new fund that may help make a positive difference. At the same time, I am painfully aware that these are difficult times for everyone. As you conduct your market research and plan your next move, it may be useful to remember that while investors may have lost interest for now, over the longer term they do need to invest. To help them rebuild confidence, it would make sense to go back to the basics and provide them with products that they understand.

In the meantime, of course, we continue to encourage innovation and new products. You will remember that at the HKIFA lunch earlier this year, I talked about some new products that we were working on with issuers. One of them is a short ETF. It is our policy that when we allow a fund product that is novel to retail investors in Hong Kong, an investor education programme to help investors understand the product, how it works and its risks is rolled out at the same time. Short ETFs are novel retail products in Hong Kong. Investor education is a key prong in our regulatory framework. We believe that both the regulator and the issuer have the duty of carrying out investor education. Right now, the issuer is working against the clock to finalise their part of the investor education programme so that we can go forward. You will recall that when we approved the gold ETF and the commodities ETF last year, the issuers also carried out investor education in relation to their products.

As has been the case in the past, we are always ready to listen, engage and consult. A strong partnership between the regulator and the industry is necessary to help restore market confidence.

Where you need a helping hand in seeking guidance with regards to any of our rules, or would like to share with us any difficulties you run into in these taxing times, our door is always open. Just pick up the phone and call.

Current status of the UT Code review

I should perhaps take this opportunity to report to you on the current status of the UT Code review. You will recall that on 16 April 2008, I spoke to you about our proposal for a comprehensive review on UT Code, and the aim of consulting the market on a revamp of the Code. In the summer of 2008, we held three workgroup meetings with different stakeholders – fund managers, administrators, trustees, legal and accounting professionals and investor representatives to hear their views on how the UT Code could be modernised to accommodate different types of product and innovation. In September, just as we were putting these ideas together into a coherent framework, the collapse of Lehman Brothers and the bailouts of different financial institutions worldwide that followed have unveiled new regulatory considerations for financial derivatives. Following this, and the concerns with respect to the sale of structured products, we have committed in our report to the Financial Secretary to consult the market on a number of initiatives relating to investment products and their selling process. The portions of our UT Code review relating to financial derivatives will have to take on board this work and its outcome and we may therefore need to conduct the UT Code review in phases. We will soon invite industry members back to discuss the way forward.

Concluding remarks

All signs are pointing to the fact that the markets will continue to be volatile. Confidence is arguably at its lowest. As fund managers, you must rise to the challenge of helping investors rebuild confidence. To do that, you, as fiduciaries, must put investors' interests first. As experts with the vital competence and experience to navigate the current storm, you are in the best position to demonstrate that you are investors' trusted partners. When investors invest in our authorised funds, they entrust their money to you, to manage at your discretion within the defined parameters of professional fund managers. As such, I am confident that you will endeavour, with all honesty and care, to put clients' money to work in the most favourable manner while treating clients fairly. These are the hallmarks of the trade and how the fund management business has always won the trust of investors. You must continue this commendable tradition.

With that, let me end by wishing you all better times ahead. And, once again, let me congratulate the award winners for their achievements last year.

Thank you.

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