Enabling Innovation in the Asset Management Industry
Keynote speech at Bloomberg Buy-Side Forum Hong Kong 2023

Ms Christina Choi
Executive Director, Investment Products

26 September 2023

Good morning, ladies and gentlemen. First of all, I would like to thank Bloomberg for inviting me to this buy-side forum and it is a pleasure to meet you all here.

I note from the agenda that much of the discussion at today's event will focus on technology and innovation. With technology advancing exponentially and boundaries being pushed every day, it is clear that there is tremendous potential for the asset management industry to integrate technology to enhance efficiency and transparency, save costs and even expand their business.

As you know, artificial intelligence (AI) has been all the rage this year, and the demand for hardware to power this technology is massive. I learnt that, to pack more and more computing power into limited space, chip technology has gone from 90 nanometres to just three nanometres in two decades. To put this into context, a sheet of paper is as thick as 100,000 nanometres. Not only does this showcase the pace of technological advancement, perhaps more importantly, it shows how changes in a tiny "chip" could bring a leap forward to the world.

So today, I will talk about how the Securities and Futures Commission (SFC), as Hong Kong's securities regulator, supports innovation and the many potential "tiny changes" in the buy-side that may bring a leap forward in market development.

SFC's role

First and foremost, the SFC's priority is to protect investors and uphold market integrity by promoting sound risk management. For buy-side players, this translates into implementing proper disclosure rules and making sure investors understand what they are signing up for. It also means managing investment risk, liquidity risk, leverage risk and counterparty risk, among others. These are critical to promoting investors' trust and confidence in your products.

The SFC's rules are principles-based and technology-neutral, and we strive to ensure they apply as well in a digital environment to protect investors and maintain fair and orderly markets.

Note: This is the text of the speech as drafted, which may differ from the delivered version.

Our second but equally important function is to strengthen Hong Kong’s competitiveness as an international financial centre and develop it as a global asset management hub. We recognise it is desirable to facilitate innovation in the products and services we regulate.

Broadening the range of investment products offered in Hong Kong, especially those offered to retail investors, forms an important part of our work. To support market development, we constantly engage the industry to facilitate novel ideas around products, and help fit these ideas into our regulatory regime for investment products in a balanced manner.

One good example is our authorisation of many new exchange-traded funds (ETFs) over the years. Many of them are the first in Asia or even globally. In 2022, we authorised the first carbon futures ETF in Hong Kong, Asia’s first virtual asset futures ETFs as well as the world’s first green bond ETF focusing on Asia ex-Japan.

Besides facilitating product innovation, we have also made enormous efforts to help buy-side firms expand their market reach, as we all know asset management is a “scale” business. This would not only help bring down the costs of products but also enhance returns for investors.

On that note, I trust you have all heard about many of the SFC’s “mutual market access” or “connectivity” initiatives to connect Hong Kong’s investment products to other markets geographically, most notably with Mainland China. These include the Mutual Recognition of Funds arrangement with Mainland China and other markets, the Guangdong-Hong Kong-Macao Greater Bay Area Wealth Management Connect programme, and the latest one being ETF Connect which was launched for just over a year with success. For example, the average daily turnover of southbound trading of eligible Hong Kong ETFs jumped twenty-fold in its debut year.

Regulation enables innovation

Traditionally, we have focused on the broad regulatory “infrastructure” that bridges retail investment funds to different geographical markets. While we will continue to work hard on further expansion of the breadth and depth of these programmes, they are not the subject of my talk today.

In tandem, fund distribution has seen a lot of innovations locally and is increasingly moving online. These innovations include digital platforms, mobile apps and robo-advisors, and they help expand the market reach of investment products. These developments have been precipitated by the pandemic in the past three years.

We see room to collaborate further with the industry in this area. After all, embracing technology to broaden the sales footprint is fully consistent with the SFC’s strategy to bring Hong Kong to the next level as a global asset management hub and private wealth centre.

Now, let me emphasise that the SFC is a firm believer in the responsible use of innovative technology, as this can make the delivery of financial services more efficient, cost-effective and sustainable. The SFC strives to provide a technology-neutral regulatory environment that encourages innovation without compromising market integrity.

Let me be clear: if there is regulation without innovation, our market would lose agility in these challenging times, but innovation without proper regulation would be unsustainable as history has repeatedly taught us hard-learnt lessons with the Global Financial Crisis in 2007-08 and more recently with the fallout of unregulated crypto platforms globally.

Thus, in my view, robust regulation is key to ensuring the industry's sustainable development, building trust in our markets and enabling further innovation.

Tokenisation of retail investment products

Circling back to innovation in the asset management industry, one recent example of proposals we have received from various product providers is tokenisation of SFC-authorised products like public funds.

We are aware of where this is coming from. Recently, amendments to Hong Kong's Anti-Money Laundering and Counter-Terrorist Financing Ordinance came into force in June this year, which have made it mandatory for all centralised trading platforms of non-security tokens to obtain a licence from the SFC. For the first time, we allow the Hong Kong public to trade a limited number of eligible crypto assets on SFC-licensed virtual asset trading platforms (VATPs), provided that these platforms comply with a range of robust investor protection measures, including suitability in the onboarding process, token due diligence, admission and disclosure requirements, segregation and protection of client assets, etc, just like other traditional SFC-licensed firms.

Now, the more traditional product providers may be wondering: "Why can't I tokenise my SFC-authorised funds or even retail structured products using blockchain technology?" or "Why can't I or other SFC-licensed intermediaries distribute tokenised products to my clients or even make them available on one of the SFC-licensed VATPs?".

In simple terms, tokenisation refers to the creation of blockchain-based tokens that represent, or aim to represent, a fraction of ownership in an investment product. The tokenised product can then be recorded digitally on the blockchain, offered directly on a mobile app, distributed by an SFC-licensed intermediary with a Type 1 Regulated Activity (RA 1) licence, or traded among the blockchain participants, for instance, on a VATP.

From what we gathered, proponents suggested that tokenisation can increase product efficiency and reduce costs. Tokenisation also enables product providers to reach end-investors through new channels (such as in-house mobile apps), with potentially fewer intermediaries and additional liquidity.

In theory, tokenisation is applicable to any assets. I have heard ideas about tokenising air tickets and physical commodities like real estate, physical gold and even crude oil.

I cite real estate as an example since it is publicly reported that an SFC-licensed asset manager has recently launched a tokenised close-ended fund investing in some real properties in Hong Kong. The fund, which is a private one for professional investors, comes with a minimum investment amount of HK$1,000 and the prospect of being available for secondary trading 24/7.

We welcome the idea of a retail tokenised product as tokenisation may help the asset management industry reduce market frictions and explore new distribution channels. In this regard, the SFC's existing product rules already offer ample flexibility for the industry to innovate. But, again, the standards we expect of such products will be high and robust.

SFC
證監會

For some proposals of tokenised products submitted to us, we note that they operate in a way very similar to a conventional open-ended retail fund. Others may go further by proposing secondary trading of a tokenised retail product on a VATP, which makes it similar to a listed product like an ETF.

As I said at the beginning, the SFC has always adopted a technology-neutral regulatory approach and the “same business, same risks, same rules” principle where we seek to see through the “substance” of any new proposals to analyse the key risks involved and how our regulations should apply.

One may ask: what are the main differences between tokenised and traditional investment products authorised by the SFC? We believe the answer lies in ownership representation and record keeping.

This is because we regard tokenisation as a “wrapper” of a product in the form of a smart contract using blockchain technology. Adopting a “see-through” approach, the underlying product itself must meet all the applicable product authorisation requirements of the SFC—be it unit trusts, mutual funds, structured products, investment-linked insurance schemes or paper gold schemes, in terms of the product provider’s eligibility requirements, in addition to other structural, investment, disclosure and ongoing compliance requirements.

However, tokenisation would certainly bring new risks as well as legal, regulatory and supervisory issues with the use of new technology, potential new service providers, new distribution process and mode of dealing in the product, both at the primary dealing level of subscription, issuance and redemption, and the secondary trading level, which have to be properly considered and addressed so that we could provide a substantially similar level of investor protection as those investing in a non-tokenised product.

The SFC is currently working on more detailed guidance on tokenisation of SFC-authorised investment products and will issue it in the near term. Our current thinking is that in principle, primary dealing of tokenised SFC-authorised products would be more appropriate to be allowed first at this stage in view of the nascent state of development of the VATP regime in Hong Kong.

On the other hand, secondary trading of tokenised SFC-authorised products on VATPs would warrant more caution and careful consideration. First, secondary trading would magnify some of the risks that might be much more manageable in primary dealing, but not so in a 24/7 trading setup. For example, secondary market trading takes place by the second. This means proper token ownership records will have to be maintained instantly. Any business continuity plans would have to match that speed accordingly.

Next, secondary trading would effectively make a tokenised product an “exchange traded product”. In this case, the VATP would function like a conventional stock exchange that facilitates secondary trading of securities and other products offered to the Hong Kong public, with the only key difference being that it is represented as a token rather than a stock.

This would inevitably raise more questions:

- Are there sufficient market makers and participating dealers to support the liquidity and arbitrage of the “exchange traded product”?

- What about liquidity mismatches in secondary trading of tokenised products, where the token trades 24/7 but the underlying asset does not? More importantly, would this affect token pricing and the broader financial market?
- Would retail investors trading tokenised fund products on VATPs understand the differences or trade-offs in pricing, liquidity, costs, risks and returns as compared with trading the same underlying fund products on the Hong Kong stock exchange?

We remain open to engage with market participants in this connection. Product providers and VATPs would need to address these questions appropriately and come up with proper measures before VATPs could offer secondary trading of SFC-authorised products.

Meanwhile, we welcome any SFC-authorised product providers to come talk to us if you are interested in offering your products in tokenised form.

Closing remarks

I have shared with you the SFC's approach to enabling innovations, in particular on the tokenisation of retail investment products. In closing, I would like to draw an analogy between our approach and machine learning.

In machine learning, a technique called regularisation is used to improve the quality of a statistical model by limiting its "freedom" and reducing "noise" in the data. In this way, regularisation makes the model more useful.

I believe "innovation without regulation" is like "machine learning without regularisation". Regulation may set boundaries on market innovation, but this is to protect the industry and investors from the recklessness of some players and ensure innovation is deployed for investors' benefit.

The longer-term success of innovation depends on us having a quality market and high standards. The SFC will continue to support buy-side innovation and development.

I hope you all enjoy today's forum. Thank you.