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Hong Kong Investment Fund Association 3rd Annual Conference "One year after the global financial turmoil - review and outlook of asset management regulation"

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Opening

This is the third annual conference of the Hong Kong Investment Fund Association (HKIFA) and my third appearance at the same event. I would like to thank the HKIFA for inviting me to speak again at this prestigious event.

I can still freshly recall that the last time I was here – we were right at the centre of the financial crisis. Or, perhaps it was just the beginning. Lehman Brothers had just collapsed and hundreds of investors had just taken to the street over the alleged mis-selling of Minibonds by banks. At the time, I said to the audience of the annual conference that our job is to put things right which means finding out what went wrong and making sure that we can design a better system going forward.

Now that a year has passed, I would like to take today's opportunity to update you on our regulatory work in the funds space. While much changes and new developments have taken place, the fundamental fact remains that the Securities and Futures Commission (SFC) has to maintain a regulatory regime that promotes market development while protecting investors' interest. On this note, I would like to thank all of you here for the support and advice that you have given us over the past year, as they have helped us in moving forward in a pragmatic but nevertheless effective manner as we develop our regulatory regime.

Dangerous regulation: Draft EU Hedge Fund Directive

Before I move on to our Unit Trust (UT) proposals, I would like to share a lesson I have learnt about regulation and seen it live in action right in front of my eyes.

As we have seen, this crisis has exposed most major economies in the world to financial downspin. Fortunately for us, there has not been any systemic failure in Hong Kong and so naturally our primary focus has been reforming and strengthening our regulatory structure and investigating mis-selling complaints for products which had failed from the crisis. On the other hand, the regulators in the US and Europe have been busy ensuring stability of their own markets and their systemically important institutions in the past months.

Precisely due to the relative stability of our markets, we have not found it necessary to make knee-jerk reactions when it comes to regulation. One recent example where this becomes an issue is the EU's draft proposal which was released back in April for new regulation to be introduced for alternative investment fund managers.

The proposal would force private equity and hedge funds, whether based in Europe or targeting European investors, to register with EU authorities. The proposal would also eventually close off Europe to managers or funds outside the EU that aren't subjected to equivalent regulation. The rules would also clamp down on how much capital such funds can borrow, force them to disclose where they're investing, and make them hold larger cash reserves.

Tighter rules, especially concerning how much leverage firms could take on might have stopped some of the abuses that prevailed two years ago. Increased transparency might also have helped investors make more informed decisions about where to park their money. However, even the review by Lord Turner of the UKFSA assigned the hedge fund industry with only a peripheral role in causing the financial crisis. Imposing strict regulation on them seems like a knee-jerk reaction that would not necessary be helpful in achieving what they would like to achieve.

Further, the rules would only serve to drive out managers and investors to outside the EU region, consequentially drying up liquidity and driving away innovation from the region that would otherwise be available. It is difficult to understand how that can be healthy for a region that is in early financial recovery mode.

Fortunately, we are already hearing that Sweden, the new EU rotating president, will be significantly amending the rules before they will be rolled out.

The lesson learnt here is not to over-react. I have spent the past twelve months giving speeches and pre-warning everyone that we should absolutely expect more regulation out of this crisis. The key to all of this, however, is and always has been sensible regulation. I have recently learnt that the Chinese use the same word for crisis and opportunity. This crisis does bring about an opportunity for markets to review and enhance their regulatory systems. After the collapse of Lehman Brothers more than one year ago, both the SFC and the Hong Kong Monetary Authority (HKMA) have kicked into review mode and have subsequently issued official reports recommending specific measures to address the issues that we believed arose from the early termination of Lehman products. We have literally spent the past year researching and fine-tuning these proposals. Today I can firmly state that we have achieved sensible regulation.

Proposed SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Scheme and Unlisted Structured Products

Now that I am back on our own proposals, I should come back to the funds space. As you know, we published our consultation paper on proposals to enhance protection for the investing public last Friday. Among the proposals is the introduction of the SFC Handbook for Unit Trusts and Mutual Funds, Investment-linked Assurance Schemes and Unlisted Structured Products to address the specific products-related matters identified in both the SFC's and the HKMA's reports to the Financial Secretary in December 2008 relating to Lehman Brothers, as well as the subsequent Action Plan prepared by the Administration which was submitted to the Legislative Council in January 2009.

Besides taking into consideration the SFC's Report to the Financial Secretary in December 2008, the revised UT Code has also incorporated new fund categories or provisions with the aim of modernising the regulatory framework for SFC-authorised funds and broadening the scope for product development.

I will now go through the key proposals of the UT Code review in more details.

Key proposals of the UT Code review

Enhancing investment flexibility

(a) Structured funds

We see the emergence of structured funds which are funds that propose to invest substantially all of their assets in financial derivative instruments (FDIs), such as swaps or repurchase agreements, in order to achieve their investment objectives. This type of funds has become increasingly common due to the proliferation of investments in FDIs. We have already authorised a number of these funds. For transparency reason and to facilitate further market development however, we have given these structures official acknowledgement by codifying the authorisation requirements in respect of these structured funds in the revised UT Code.

(b) Investment in FDIs

The revised UT Code also introduces provisions for regulating investments in FDIs by non-UCITS schemes which are generally managed by SFC-licensed asset managers, in order to provide a broadly level playing field between non-UCITS schemes and UCITS schemes. The approach of regulation is largely similar to UCITS such that non-UCITS schemes may invest in a wide range of financial derivative instruments, as their UCITS counterparts do. Of course, we expect the SFC-licensed managers to ensure that their risk management systems and controls are commensurate with the nature and scale of FDI investments that they engage in. We believe that Hong Kong has the ability to develop into the asset management hub of Asia and the wealth management platform for Mainland. To this end, it is important that we enhance our regulatory regime so that non-UCITS schemes are given space to innovate.

Promoting investor protection

(a) Product Key Facts Statement ("Product KFS")

The introduction of new fund structures and capabilities makes product disclosure all the more important.

In the past year, one of the messages we have obtained from the market is that not all investors read the product offering documents before making their investment decisions because the documents are often too long, and it is difficult to identify the important parts. Instead they rely on marketing materials which have the sole purpose of attracting investor attention to the products being featured and may not contain all the relevant risks associated with the product, simply because they are much briefer.

To cater for most investors' practice we have developed a Key Facts Statement. Its concept is very much akin to the proposal by the Committee of European Securities Regulators with respect to key information document. They are intended to be user friendly, standardised to the extent possible (to facilitate comparison between products), and be kept concise. In principle, this Key Facts Statement will comprise part of the offering documents of the product and have equal force and standing as the prospectus – yet it will be limited to only a few pages in length so as to highlight and facilitate investors' appreciation of the key features and risks of the product.

At the same time, we are also open-minded that some UCITS schemes may already be using a specific form of key factsheet that satisfies their home regulator's requirement. Keeping in mind a large proportion of our funds are UCITS funds, we incline to recognise and accept these European key factsheet counterparts provided that they in substance provide the same information as required under our Product KFS, and their format and presentation are user friendly and easy to understand. We would like to hear your views on this.

(b) Bilingual annual reports

In view of the demographics in Hong Kong, there is good reason for schemes that are marketed in Hong Kong to produce both English and Chinese language annual reports. It also enhances transparency, thus contributing to investor protection. We propose that annual reports must be published in both languages for local funds which have Hong Kong investors. For non-local funds, we are aware of concerns expressed by some overseas fund managers of the additional cost and time involved in preparing a Chinese annual report, given that Hong Kong is only one of the many jurisdictions that they offer their schemes. Therefore, publication of a Chinese- language annual report is voluntary among recognised jurisdiction schemes, though we hope that going forward, such funds will also provide bilingual annual reports.

Participation from the industry

The aim of revising the UT Code is to modernise the regulatory framework for SFC-authorised funds, facilitate product development and provide a broadly level playing field between UCITS III funds and local funds such that local managers are given a wider space to develop. The longer term objective is to create an environment whereby our local managers could grow, thus further strengthening Hong Kong's position as the wealth management centre in Asia.

We appeal to the industry's support and contributions in this important exercise. We need your valuable feedback to make the revised UT Code practicable. Your responses to the consultation are therefore most encouraged and welcomed.

Thanks.