

Deacons Regulatory and Compliance Forum

“The Shape of Things to Come”

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Introduction

It is a great pleasure to be here to address you all this afternoon, although I'm a bit overwhelmed by the title of the speech I've been given – “The Shape of Things to Come”. Being a humble sort of person, I thought I am qualified, first of all, by using the words of Donald Rumsfeld, the ex-US Secretary of Defence, who was in a very difficult position when the US invaded Afghanistan.

Mr. Rumsfeld, who was in the middle of a lot of queries and a lot of objections to the US strategy, decided to clarify the situation for them, just as I am going to clarify for you today.

He divided the world into three parts. He divided the world into not just what we know and what we don't know, but what he called the “known knows” – they are the things that we know because we got experience, or we are in control of them. The “known unknowns” are the things that you think may happen, but you are not quite sure, so that is part of our experience or it might be something in the future, but you don't know if it will happen. Lastly, the “unknown unknowns” - and I really don't know what they are.

What I'm going to talk about in terms of the shape of things to come, is mostly the “known knows”. They are what we know and what we have seen, what we have experienced through this particular crisis, and what we will do in response to it.

A little bit on the “known unknowns”, but not too much, because they are unknowns. But for me, the “known unknowns” are what we have been through that will occur again in some form. We don't know when and we won't know in exactly what form. But if history has ever taught us anything about the financial markets, the lesson is that the crises we go through, the meltdowns that we go through, seem to happen rather more frequently than you would expect. We can assume, therefore, that we will feel another meltdown in some form in the financial sector, but we don't know when.

Our objective, as the regulator of the fund space, as the regulator of securities space generally, is trying to create structures which as far as possible minimize that “known unknown”. That is what we try to do in terms of the process that we go through – how we consult with you and how we bring forward our proposals.

I know many of you are thinking, and in particular those in the fund space are thinking – why us? So I'd like to put a little bit into context, the process at the global level that we've gone



through, and then bringing a little bit more now to the local level, and then we'll talk about the consultation process that we've been going through and the sort of outcomes – what we think will be the outcome of that process.

Firstly, on “why us”. Let me start with the macro level first. The “why us” at the level of Hong Kong, or countries, is quite an interesting question. Because when you look at the crisis that we've come through, we have got failed investment banks in America, we've got failed retail banking in Germany, Spain and the UK. We've got Ponzi schemes and hedge fund that have collapsed in the US, we've got the brokers that have failed – there are something like 120 banks that have failed in the US. Actually what we've got is a lot of what I call institutional failures in Europe and in the US – but not here in Hong Kong, nor in Asia. But actually the remedies that are being produced, the remedies that are being put forward are coming forward from the G20 groups with a view that says: “When we have designed the remedy, whatever the remedy is, if the remedy is good for the US capital market, good for the European capital market, then we will all adopt it.” In a sense, it is almost like 20 people who have gone through one of these hyper marathons that people run through the Sahara desert. Three of them come through and they are very healthy. Three of them come through and have blisters. Three of them are on life support. And what you do is let's see what those on life support need. We'll design a remedy for them, and actually all you healthy ones got to take it as well. In a sense, that's the process that we are in. That's what the G20 process is about. It's about making sure not that we get solutions to problems that didn't exist here. It's about making sure that when we go to the next stage or when the next crisis emerges, we haven't created pockets in the world where there is either a lower standard of the level of capital changes, or easier ways to book OTC products to take them away from the transparency of the exchanges. So that's why on responses at the macro level, we will all input or implement the solutions that are deemed appropriate for the sick patient.

How do these relate to us? What is the relevance here? Of course, what we have at the micro level is the thing that did go wrong in Hong Kong. It was the selling of complex products to retail investors, and in particular, the selling of credit-linked structured product to individuals who should not have been in these products because of low risk tolerance, low risk aversion, and having put a significantly large part of their assets in a single product. That was a product not well understood. So we've started the process to say- ‘what went wrong?’ What went wrong was actually relatively simple. What went wrong on the client side was the failure to properly understand and to properly ask questions about the risks of the products. They were buying from banks and they assume that they can trust in the banks that the products must be suitable for them. On the distributor side, which is largely banks, what went wrong was a failure to properly do the piece of work which is very fundamental in our Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct) – understand your client and make sure the product is suitable. On the manufacturers' side, what went wrong was a washing of hands of the product at the point they have left the door – it's not our problem anymore. We've got somebody to sign this to the agreement, that when they sell the product, it will be sold on a reasonable basis only to people who understand it. So that's it. End of story for us. In a very simply sense, that was not what went wrong. It wasn't that there was a lack of clarity of what our Code of Conduct represented. There wasn't a lack of regulations that explain what should happen. There was a failure to implement properly requirements under the Code of Conduct.

So we started the process of looking across retail products, not just the structured products



space, and we are going to make many changes. Do we make changes to the narrow part of our product space, or do we try to come up with a set of changes which cover a broad range of products that are sold to retail investors, or certainly the broad range of product that the Securities and Futures Commission (SFC) had involved with that are sold to the retail public.

What we did is that we took the approach that we can't rely on just on addressing one particular type of product because the truth is that financial products are converging. They are converging in a sense that we do not have very simple distinctions anymore between funds and exchange-traded products and structured products. They are converging in a sense that almost any economic disclosure can be wrapped up in one of those wrappers, and we'd rather have a standard that works across all of them than simply create incentive that says: 'Well, that part of the space is now more constrained, more regulated.' We'll shift our focus and create products in this other space which is not so regulated.' So that's the sort of process that we are thinking through here in Hong Kong. It's the same thought process that the Committee of European Securities Regulators (CESR) and many other regulators around the world are going through.

So that's my way of introduction. We have a problem to solve. The problem we have to solve at the macro level is of the financial system that broke down. We are trying to understand what the moving parts were, what was that broke down, what remedies we make to address that, and how do we bring those forward at a global level. We're trying to solve the problem that at the local level, we had one particular flavour of products that broke down, but the recognition from us that actually going forward, products are going to get more complex, will converge and will blur across the edges, so we are right to take the view now to come up with a solution that works across a broader range of products.

I know those of you who are active in the retail fund areas are going to be interested in the results of our recent consultation on proposals to enhance protection for the investing public and I'm going to spend a bit of time on that.

Obviously, the reforms will shape the development of the market of retail investment products in Hong Kong for some time to come. Aside from these specific and more immediate changes, we need to keep in mind some of the broader issues that governments, regulators and supervisory bodies have identified as a result of this crisis. We're seeing reconsideration of the process in quite a number of areas, with a view to improving regulations, which hopefully doesn't mean increasing or imposing additional costs, but improving regulations in so far as it applies to conduct and prudential requirements. What we're also seeing, and again globally as it is the case, much more importance has been placed in ensuring the consistency of basic standards across different jurisdictions. The approach to be taken – or yet to be taken - (as some of them are fairly advanced, while some are still in the conceptual phase) on these issues in various places around the world will also play a large part in determining the regulatory framework within which all of you, as participants, will be expected to operate going forward. This obviously includes the fund industry here in Hong Kong. So I will offer my perspective on some of these issues and discuss some of the work the SFC currently is doing in the international arena as well.

The September and October 2009 Consultations

I think all of you are probably aware that the SFC recently published conclusions in respect of our proposal to reform certain aspects of the offering regime for investment products in



Hong Kong. The consultation in respect of these reforms ran concurrently with another much larger consultation we launched in the last quarter of last year, which is looking at investor protection for the public in a broader sense. We haven't yet published our conclusions. We will do it very shortly. The proposals in both consultations will clearly impact the industry here in Hong Kong. I am sure that you will have read, or been advised by your lawyers or others, on the recently-released consultation conclusions on statutory reforms, and you will be aware of the potential impact on your businesses and interests. So what I'll mostly focus on today are the investor protection measures that relate to our consultation on product and on conduct in the last quarter of last year.

The “investor-protection” consultation: a brief summary

The consultation paper we released at the end of September last year comprised a variety of measures aimed at improving transparency and disclosure in respect of a broad range of investment products. It proposed increased requirements covering sales practices for investment products and other obligations for intermediaries. Some of the proposals are direct responses to the financial crisis. Others, to be honest, are reflecting the evolution of the markets, and in some ways a catch up on the development we've seen over the last few years. And what we've chosen is also to take the opportunity to clarify, codify or streamline regulatory requirements in some of the areas covered by the consultation.

The product-related proposals affect not just retail funds, but also investment-linked assurance schemes (ILAS) and structured products that are offered to the public in Hong Kong. We've drafted a new code setting out requirements for authorization of documents relating to unlisted structured products. I think we're probably the first jurisdiction in the world that has come up with a code for structured products. We've also proposed some changes to the codes covering collective investment schemes and ILAS. We've also brought the new and revised codes together within a products handbook, which is a set of broad principles designed to supplement and assist in the interpretation of the product-specific requirements.

The sales-related proposals in the consultation have included enhancements to the “know-your-client” process for intermediaries and proposals covering disclosure of commissions and the use of gifts. I am sure you would be delighted to know that we'll see rather less coupons for Park'n'Shop and flat screen televisions and all of the other incentives that were used to sell the products, but were, in many ways, a distraction from the complexities and the embedded risks of the products. We've invited reconsideration of when investors should be viewed as “professional investors” for purposes of their dealings with intermediaries. We've focused on the fact that, in law, there are only retail investors and professional investors, but there is very much something that we found through the private banking network that there was a blurring between private investors and professional investors, and we're trying to come up with clearer distinctions in that area.

Ongoing objectives and policy intent

Coming back to our topic this afternoon, and staying with the Hong Kong market for the time being, the general principles and objectives underpinning the proposals in the September consultation are, I hope, indicative of our policy intent going forward. We've focused on greater transparency for investment products, and basic requirements and standards for product providers and other parties playing key roles in respect of investment products. We've provided increased details on requirements for fulfilling the general disclosure



standards applicable to these products, not just in offering documents but also in advertisements. We've focused on making product disclosure more user-friendly for investors. We've gone from a position where in some products you will face with a choice of either two 100-paged documents which disclose all the risks of the product because the lawyers would make sure that all the risks are disclosed, or a one-page flyer usually with a pot of gold in the middle of it. Neither of the documents actually do the job of informing the investor of the risks and features of the product, so we would like to make product disclosure more user-friendly.

We've proposed that the "know-your-client" process should involve additional assessments in specific areas when intermediaries are selling certain complex products, in particular, products that have included derivatives within them. We're also adding certain post-sale disclosure requirements in some areas so that investors will be better able to track performance of their investments.

Of course, ensuring that investors are given sufficient information to make informed judgments is one part of the equation. As we have come to know in our investigations we have gone through, and noted several times in our consultation paper, we are also making considerable efforts on the investor education front, to inform clients the sort of questions they should be asking and the sort of features they should be looking at. Arguably, in many cases, the clients didn't do enough themselves to understand the products they were buying. And another equally important policy objective is to provide financial literacy to the broad range of investing public so that they can provide themselves the first level of protection against mis-selling and potentially mis-buying of the wrong products of a particular set of characteristics.

Implications for the fund industry in Hong Kong

For the retail funds industry in Hong Kong, although our consultation proposals will increase in some areas of compliance burdens, in other areas we are hoping we are introducing more flexibility or a reduction in compliance burden.

One of the key extra requirements, which is the focus for many people, is the requirement for a Product Key Facts Statement (Product KFS). This is intended to be a concise, user-friendly document summarizing the risks and features of an investment product. This won't just apply to funds. It will apply to all those other products that are authorized by the SFC. A Product KFS will need to be prepared for all products in our products handbook. Obviously, we recognize there are a huge number of funds existing in the market today and we understand the need to allow sufficient time for the broad range of products to be brought in compliance with this new standard. We will work very closely with the industry to allow sufficient transition period to make sure that we do not overburden you or indeed us in trying to move too many products to this new standard too quickly. So we'll work with you to ensure that it is a smooth and efficient process.

As I mentioned, the proposals in the September consultation do offer increased flexibility for funds and their managers in some areas. We're proposing to allow greater scope for non-UCITS funds to invest in financial derivative instruments, as it has always been pointed out the anomaly that Hong Kong-based funds suffered from more restrictions than funds that are sold in Hong Kong as UCITS funds. We're proposing to allow funds greater scope to invest in other funds, and to allow managers to adopt alternative bases for calculating and charging



performance fees, subject to some basic limits and the fund's own contractual and regulatory considerations.

The international arena

Although it wasn't the subject of any of the specific proposals in the September consultation, some respondents took the opportunity to ask us to consider expanding the number of jurisdictions we recognize as equivalent to Hong Kong for purposes of authorization of funds or approval of managers. This is an area where we are always very active in trying to provide opportunities for market participants and wider choices for investors. You would see that last year, we signed a side letter with the Taiwan Financial Supervisory Commission and also the Memorandum of Understanding (MoU) with the Securities Commission of Malaysia, in addition to the declaration of mutual recognition that we have signed with the Australian Securities and Investment Commission. All are intended to provide a higher degree of mutual recognition, a greater capability to cross-sell products from one market into another.

Broadly speaking, all of these MoUs and side letters we signed with other jurisdictions are premised on the basis of mutual recognition, i.e. there should be two-way, mutual cross-offering of funds managed by managers in the respective jurisdictions. As such, and in order to properly protect investors' interest while at the same time providing investors with investment choices, we require that the relevant jurisdictions to have at least comparable regulatory requirements and investor protection mechanism in place. The regulator of the relevant jurisdiction has to agree to provide certain information to us, to provide certain assistance to us in the event of having us to investigate into any product or issuer of product. And in addition to the regulatory assessment, obviously we have to look at the maturity of the particular market in the relevant jurisdiction, the size and depth of this market, and whether the nature and stage of its development are appropriate for recognizing as a mutual basis with Hong Kong. Although this mutual recognition point isn't going to be part of our forthcoming consultation conclusions, it is something that was raised with us by a number of people, and it is something we currently got underway and we will come out with our thought on this a little bit later on.

International co-operation and common themes

You all know that we're not the only regulator proposing the sorts of changes we've come forward with. As I said from the start, this financial crisis has affected every market in the world, certainly every major financial jurisdiction, and therefore there is a great deal of work done in other jurisdictions which are looking in parallel the sort of issues we're looking at. We work very closely with these other jurisdictions to make sure that any proposal that we put forward are broadly aligned with other jurisdictions, or at least, if they are not, that we understand the reasons for the differences.

A good example of these is the Product KFS, the Product Key Fact Statement that I talked about earlier. It is something that has been talked about in many jurisdictions around the world, particularly in respect of retail clients. We have, in Europe, the proposal for "Key Information Documents" or KIDs being proposed by CESR, "Product Highlights Sheets" being proposed in Singapore, fund fact sheets in Malaysia and "Key Information Memoranda" in India.



We recognize that many investment products we see here in Hong Kong are offered in many jurisdictions at the same time, and the relatively small differences in the regulations between jurisdictions can actually add up to significant compliance costs and logistical difficulties when distributing products across a number of jurisdictions. We also believe that these short-form summary documents should be designed to be useful to investors as a means of comparing investment products. Thus what we are trying to ensure is on the one hand, the degree of consistency with the other demands for short-form document, but also sufficient flexibility to recognize the documents that are produced in other jurisdiction without unduly compromising the level of communication and the level of protection to the investors.

Consistency of approach is important for a number of other reasons. Product providers often have a choice of structure, a choice of platform or a choice of programme, and a choice of offering channel. Products with similar features and risk profiles should be subject to similar requirements, regardless of whether they are offered as structured products or as funds or linked to insurance policies, and regardless of distribution channel. These considerations apply not just between segments within our market here in Hong Kong but also internationally. We are therefore seeing increased focus by regulators and supervisors on the substance, risk profile and economic features of investment products, and not just their legal form.

Take the Product KFS and the European KID as an example. We understand that managers of overseas funds have to deal with the KID requirement in their home jurisdictions and the Product KFS requirement in Hong Kong, and thus they are under pressure to comply with two sets of regulations while minimizing the costs of launching a product. At the same time, we emphasize that investors in each jurisdiction will have some differences and we need to make sure that the local differences are also protected. What we will do, and it is still early stage because KID is still in discussion, is as far as possible, we will examine whether the European KIDs can be distributed in Hong Kong and meet the Product KFS requirements without additional disclosures. If there have to be additional disclosures, obviously we'll try to minimize the impact on costs of doing that. Our aim is to create a win-win situation where both investors and product issuers in both markets have a simple way to access to the core information that they need without the additional costs of complying with multiple jurisdictions.

We now not only work with CESR on product documents product disclosures, but also with all of the other global regulators directly through the International Organization of Securities Commission (IOSCO) and the Financial Stability Board (FSB) in an attempt to minimize the additional costs of the new regulatory structures that will be coming forward. We've done that in a number of areas. We've done that in terms of examining point of sale requirements. We are doing that in terms of the new regulations that will be required for credit rating agencies and hedge funds, and we've done that in relation to short selling rules where Hong Kong very much took the lead in establishing a framework for how short selling can be implemented across all global markets without causing the dislocation, the very sudden changes that the rules created in 2008 and 2009.

That's the commitment we will have. We understand the costs that the additional regulations or the changes in the regulations create for the industry. We are driven, first and foremost, by protecting investors, but also to ensure that the Hong Kong industry is an effective and an internationally competitive one. And to that end, we will try to ensure that the regulatory changes, that the proposals we put forward are justified on a cost-benefit analysis, are



justified for the additional protection they bring against the additional costs they may bring to the industry.

Conclusion

In conclusion, coming back to my theme, “The Shape of Things to Come”, I’ve talked about the “known knowns” i.e. what we’ve been through, what we’ve understood and what we will do in response to that. We will produce a products handbook which will set out standards expected for most products and documents aimed at retail investors. We will finalize our codes and consultation conclusions very shortly. Going forward, the policy objectives underpinning the specific requirements will indicate our regulatory intent of providing additional protections to investors and maximizing the attractiveness of the Hong Kong market.

We remain committed to our efforts to help fortify Hong Kong’s role as an international financial centre. We continue to work on initiatives that offer opportunities to broaden and deepen Hong Kong’s markets and more choices to investors. This will involve more work on bilateral agreements or MOUs, more work on the international platform, such as working with the IOSCO and within the FSB. And most importantly, more work with you in seeking your input to make sure that the changes we bring forward are sensible, balanced and can help develop the Hong Kong market.

Thank you very much indeed.