The Outlook and Regulatory Challenges for the Fund Management Industry in Hong Kong

18 January 2007

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Ladies and gentlemen,

Thank you for inviting me to speak to you today.

When I was asked to give this presentation, I was wondering how to make talking about the fund management industry from a regulator's viewpoint interesting. It's a challenge but then I realised that in at least one respect regulators actually share the same objective with the industry, which is to ensure that our markets compete successfully in the face of global competition.

As regulators, we constantly ask ourselves whether our regulatory framework is doing what it needs to do to continue to attract liquidity to our markets.

We believe it is a given that we should not over-regulate, nor should we be, or even appear to be, heavy-handed, or funds will be put off by the high cost of compliance, and investors will also suffer by having far fewer products to choose from.

On the other hand, we take our role as gate-keepers very seriously by firmly and fairly enforcing the relevant codes and guidelines. Another prerequisite for attracting liquidity is that the investors are treated fairly, and rules are properly enforced.

Regulatory objectives

The Hong Kong Government and regulators are committed towards developing a quality market with both breadth and depth.

Recent industry-friendly measures include abolishing estate duty and exempting offshore funds from profits tax in late 2005 and early 2006 respectively. These measures are meant to strengthen our competitiveness as an international financial centre and attract international investors to hold assets in Hong Kong and to use our asset management services. During this period, we saw 73 corporations coming in to apply for an asset management license.

We also provide a robust regulatory framework to ensure that market players have a level playing field and sufficient market transparency for investors to make informed investment decisions. I will say more about this later but the important lesson is that this obviously cannot be achieved by working in a vacuum. As regulators we always try to work with the industry when we formulate regulatory policy or facilitate the development of new investment products. This also gives us the feedback we need to remove obsolete policies that hinder innovation and change.

Hong Kong as a major international financial centre

Hong Kong is widely recognised as a major fund management centre. We are ranked 2nd (after the Mainland) as the most preferred destination for foreign direct investment[1] in Asia.

The fund management industry in Hong Kong is thriving. It has enjoyed substantial growth in assets under management over the past few years. The combined fund management business grew by 25% in 2005 and over 22% in 2004. The size of Hong Kong's combined fund management business at the end of 2005 was more than half (55%) of Hong Kong's stock market capitalisation at that time.

Opportunities in China

No talk about Hong Kong's financial markets would be complete without mentioning Mainland China. The Mainland is an important focus point in the financial world today for good reason as the Mainland's economy is expanding rapidly, with the world's biggest saving pools (US$2 trillion according to market sources) and the world's largest foreign currency reserve of over US$1 trillion[2]. Such liquidity brings significant opportunities for both investors and asset managers.

In 2006, the Mainland's domestic A-share market surged 130% and domestic mutual funds topped US$100 billion. This increase of the size of the domestic mutual funds was largely driven by two factors – a big shift in investments from money market funds (investing in short-dated bonds) to equity products as well as the sizeable jump in China's domestic A-share market.

The asset management industry in China is also enjoying rapid growth – there has been a 10 times increase in total assets under management within six years between 2001 and 2006. In one year alone, total AUM jumped by 84% (from US$59 billion in 2005 to US$107 billion at the end of December 2006).

The sheer volume of Mainland investor money hungry for investing opportunities is a well documented phenomenon. As an example, a new Mainland joint venture fund management company between Harvest Fund Management Co. Ltd. and Deutsche Bank saw a bumper fund launch in the final quarter of 2006. One of their new funds was able to receive US$5 billion in subscription money in just one day.

So, the question now, is how does one tap into the lucrative Mainland market? Although the market is opening up at an unprecedented rate, restrictions abound. The most significant measures introduced by the Central Government to date to open up the Mainland's financial

[1] Source: World Investment Report 2006, United Nations Conference on Trade & Development
[2] (US$1,010 billion, according to The National Bureau of Statistics, Ministry of Commerce, and General Administration of Customs)

markets are the QFII (Qualified Foreign Institutional Investors which are allowed to invest in Mainland securities) and QDII (Qualified Domestic Institutional Investors which allow Mainland investors to invest in overseas equity markets through qualified institutional investors e.g. fund management companies) schemes. By obtaining QFII status, Hong Kong asset management companies can directly play the China securities market. There are currently 52 approved QFII with a total quota of US$9 billion for investing in the Mainland securities market. We have seen some of these QFII quotas used to package retail fund products in Hong Kong.

As for QDII, although they offer notable investment opportunities for Mainland investors, the take up rate has been slow. At the end of December 2006, SAFE (State Administration of Foreign Exchange) granted a US$13.6 billion quota to approved QDIIs, of which US$13.1 was granted to 15 bank QDIIs. However, the actual investment in QDII products totalled less than US$400 million, a rather low utilisation amount. The remaining US$0.5bn was granted to for Hua An (a Mainland based asset management company).

Bank QDII products are not doing as well probably due to (i) lack of product diversification and low return from fixed income due to restrictions in the current bank QDII rules to bonds and fixed income products; (ii) anticipated continued appreciation of RMB exchange rate; and (iii) pick up of China's stock market which made buying A shares more attractive.

To address these issues, the first joint working group meeting of CBRC (China Bank Regulatory Commission), SAFE, SFC and HKMA concerning QDII was held in November 2006 in Hong Kong. The working group recognized the importance of widening the scope of permissible investment of QDII banks and discussed the possibility of expanding the scope to include products that are familiar to Mainland investors (e.g. SFC authorized funds that invest in H shares listed in Hong Kong).

Hong Kong as a gateway for Mainland investors

Hong Kong is ideally positioned to act as a bridge between the Mainland and the rest of the world. We enjoy close relations and proximity to the Mainland, and are also familiar with the languages, cultures, practices and systems of the Mainland.

As a leading asset management centre in Asia, our fund management industry has an international and offshore flavour. Around 60% of investment funds available are sourced overseas and the majority of assets are invested outside Hong Kong.

In terms of human resources and services, Hong Kong possesses a rich pool of talent and can offer a comprehensive set of skills, experience and advisory services for Mainland institutions seeking to invest overseas. With a broad range of authorized investment products that can cater to all levels of investors with different risk appetites, Hong Kong provides a one-stop shop for Mainland investors who are enthusiastically seeking to diversify their investment opportunity overseas. This complementary and highly synergistic situation benefits the Mainland and Hong Kong fund management industry.

I suggest that Hong Kong based fund managers take this opportunity to explore the possibility of how they could contribute to, and benefit from, the opportunities that QDII opens up. For instance, they may wish to conduct market research to determine what type of fund products, or what kinds of underlying investments, would be of interest to Mainland investors.

Global issues for the fund industry

Let me now turn to some of the global issues regarding the fund industry faced by regulators in major markets around the world.

(i) Regulation of hedge funds

The first issue is the regulation of hedge funds.

We in Hong Kong feel that hedge funds are an exciting product and should not be altogether barred from the retail public. Indeed, we were one of the first jurisdictions in the world to introduce guidelines to facilitate the offering of hedge fund products to the retail market. However, bearing in mind that retail investors may have less resources available to them to demand adequate risk transparency and structural safeguards, we have imposed stringent requirements on the structure, fund managers' competence, performance fees disclosure, etc.

As you all know, retail hedge funds are only a very small part of the hedge fund universe. The vast majority of hedge fund managers who are in Hong Kong manage or advise private hedge funds. We conducted theme inspections in 2005 on a sample of hedge fund managers. Last November, we carried out joint inspections with the US Securities Exchange Commission on a sample of hedge fund managers licensed/registered with both regulators.

From these inspections we have uncovered some key areas of concern, which include:

(1) Side letters

Some fund managers give preferential treatments to certain investors through side letters without adequate disclosure to other investors, which can lead to unfairness and conflicts of interest.

Disclosure could be one of the solutions to this problem, e.g. AIMA issued guidance on side letters in September 2006. Fund managers should disclose to investors the existence of side letters and their material terms, such as preferential redemption rights, portfolio transparency rights, etc.

(2) Valuation

Some managers were found not to have clear valuation policies, such as the valuation methods for complex and illiquid products.

(3) Substandard offering documents
Some of the terms in the offering documents of hedge funds were ambiguous.

We are working closely with the industry, other regulators and IOSCO to look into these issues and how best to address them. For example, we actively participate in the IOSCO Task Force on hedge fund valuation from which IOSCO expects to receive comments from the public on this topic in the summer of 2007.

(ii) Mis-selling of products

The investing trend nowadays sees Hong Kong investors demanding yield enhancement, capital preservation and diversification away from the traditional asset classes such as property, shares and foreign exchange. In addition, as the population ages, there is increasing demand for sound retirement planning.

With these objectives in mind, investors are attracted to the wide range of traditional unit trusts and mutual funds, hedge funds and other collective investment schemes, structured products as well as investment-linked insurance policies (ILAS) on offer in Hong Kong. In this competitive environment, there is also plenty of aggressive marketing and product pushing to attract retail investors.

Given this situation, the typical retail investor faces a bewildering and possibly confusing range of choices due to product complexity, difficulty in understanding offering documentation and possible conflicts of interest on the part of the intermediary selling the product. These factors make it difficult for the typical retail investor to make a reasonably informed investment decision. Because of this, more and more investors turn to their investment advisors for objective and appropriate advice. The onus, therefore, is on fund managers to provide suitable training to distributors and investment advisors to ensure that they provide professional and objective investment advice to their clients, including all necessary information about the features and risks of the products, and most importantly, unsuitable products are not sold, or “pushed” to investors.

Ongoing investor education plays an important role in helping investors know their rights, responsibilities and risks when seeking advice from investment advisors. In this regard, the SFC will continue to educate investors through different channels via the media, workshops, publications and our comprehensive online investor education portal - “InvestEd”. The aim is to help investors develop the right attitude towards personal financial management. Once investors understand the features and risks of the product they are thinking of investing in and learn to ask the right questions, they will be better equipped to make informed decisions.

Regulators are generally in agreement that investors should have the opportunity to base their investment decisions on solid information when considering their investment options. Whether an investor is guided by a salesman's recommendations, disclosure in the CIS operator’s prospectus or is largely self-directed, the investor should have, before buying, the information necessary to understand what he or she is buying, its cost and its risk/performance profile, as well as a market intermediary's associated conflicts of interest.

In Hong Kong, it is current market practice for investment advisors not to disclose to clients the quantum of their remuneration or commission which they receive from product providers. This creates conflicts of interest issues in that investment advisors may put their own interests ahead of those of their clients.

A new IOSCO project will consider the kinds of meaningful and effective information that ought to be disclosed to investors at the point of sale. The SFC has volunteered to be part of the drafting committee. Already such types of disclosure are mandatory in Australia, UK and Singapore.

(iii) Use of soft commission

Soft commission arrangements is another area of concern for regulators as they give rise to conflicts of interest issues between the fund manager (who receive benefits) and the fund and its investors' interest (in paying the lowest commission rate available and obtaining best execution of the funds' transactions).

The SFC's Code of Conduct requires a licensed person to disclose soft dollars received from a broker and their approximate value to the client. A licensed person is also required to ensure that the transactions undertaken or services acquired are in the best interests of the client.

IOSCO issued a consultation paper on soft commissions in November 2006 to examine any issues of concern and regulatory responses among its member jurisdictions. The UK Financial Services Authority has taken the initiative to require investment managers to disclose to their clients how much they are paying for execution and research services, i.e. to unbundle the commission.

We are keeping a close eye on further international developments in this area.

Conclusion

Hong Kong already has a robust regulatory framework in place, which is bolstered by a large pool of talent, experience and world-class financial services and legal system and a deep, broad pool of well-managed investment products. We are well poised to provide value to Mainland investors looking for better choices and services, and to benefit from the synergy and opportunities that the opening of the Mainland market offers. This is a historic moment, and we live in an interesting time. We should all work together to make the road ahead meaningful and beneficial to all investors and market players.

Thank you.