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"Towards the Hong Kong Fund Supermarket – a new Code on Unit Trust and Mutual Funds"

Alexa Lam
Executive Director and Deputy Chief Executive Officer

Good afternoon ladies and gentlemen.

I would like to thank the conference organizer, ICBI, for this opportunity to share with you our philosophy and experience in the regulation and promotion of the Hong Kong fund industry. What I plan to do in the next 30 minutes is to paint the current landscape of our fund management industry, explain how we have used our regulatory framework, essentially the Code on Unit Trusts and Mutual Funds ("UT Code"), to support the development of this industry, and tell you about our work plan to completely revamp the Code to make the regulatory road simpler, easier and faster for the market.

Overview of the Hong Kong fund Industry

First, where we are today. The industry had a remarkable year in 2007. According to the Hong Kong Investment Funds Association, the fund industry registered gross sales of US$45.5 billion and net sales of US$6.9 billion in 2007. These figures are not only over 80% higher than the levels in 2006, but also the highest in record.

Year 2007 also marked a number of records for the Commission. Based on the latest available data, the aggregate net asset value of SFC-authorised funds broke the US$1 trillion mark at end 2007 (at nearly US$1,060 billion). The number of SFC-authorised funds also reached a new high (at 2,040), breaching the 2,000 level for the first time. These funds cover a wide spectrum of investment strategies, asset types and country exposures. They were all well-received by the investing public, made possible by the work done both on your part and ours in educating our investors on these new and innovative products. For those of us whose professional aspirations must necessarily move within the confines of the UT Code, vintage 1997, it is reassuring to note that we have been able to authorize all these funds under the UT Code. Yes, we have had to construe the UT Code in a purposeful manner, but between our willingness to be flexible and your ability to adapt, we succeeded in bringing all these new products to market.

Review of the development of retail fund industry in Hong Kong

Now a bit of history. Fund investment was introduced in Hong Kong in the late 1960's and early 1970's, when British commercial banks established business here to provide fund management service to pension funds and expatriates living in Hong Kong. Fund managers from the US joined the industry in the 1970's. As funds gained popularity among retail investors, the government formulated the Code on Unit Trusts in 1978 to lay down the basic framework for regulating retail funds. The administration of that code was transferred to the Commission in 1989 following its establishment. It was replaced by the Code on Unit Trusts and Mutual Funds issued by the Commission in 1991.

Since its inception, that code had been amended from time to time to accommodate new trends and market developments, such as the offering of guaranteed funds and futures and options funds. In 1997, the Commission conducted a thorough revamp of the code to adopt a new and more flexible structure for authorization of funds. This is the UT Code that we are using today.

Structural advantage of the UT Code

The revamped UT Code adopted a new structure to clearly set out the authorization requirements, which makes the fund authorization process more transparent. To provide for flexibility, the UT Code stipulates basic operational safeguards that an SFC-authorized fund must possess, but it does not compartmentalize funds into pre-determined categories, unless they are specialised funds which by their nature have very unique characteristics and thus warrant specific provisions. To build critical mass of funds, we adopted an expanded list of recognised jurisdictions (the RJS scheme) whose authorized retail funds may be authorized here under a simplified process. As well, we recognised a list of regimes whose supervision of investment managers is accepted to have broad equivalence to our own supervision (the AIR scheme) such that these managers could qualify as managers of retail funds that we authorize. These schemes have enabled overseas funds with overseas managers to be authorized here. This has greatly expanded our universe of funds for retail, and has provided the impetus for rapid and successful growth of the fund management industry in Hong Kong. By encouraging the entry of overseas funds, we have also expedited the development of fund management skills in Hong Kong, and allowed our local managers access to the skills and experience of a deeper and broader talent pool.

Administrative flexibility provided by the UT Code

While the core provisions of the UT Code have largely remained unchanged since 1997, through appropriate additions and fine-tuning to the UT Code, and with the help of circulars to provide added guidance to the market, we have over the last 11 years succeeded to make the UT Code a living document that accommodates different new products. Hedge funds, guaranteed funds and index tracking exchange-traded funds are some of the products that we have introduced in the market by way of new chapters added to the UT Code.

With products that have new or innovative features, we have used circulars to clarify that the UT Code provisions could be applied to enable their authorization. You know of course that we are the first regulator in Asia to issue guidelines to facilitate the authorization of UCITS III funds under the UT Code. By working very closely with the industry, the Commission issued interim measures in March 2005 that set out practical and concise requirements for all UCITS funds seeking authorisation by the Commission from Luxembourg, Ireland and the UK as UCITS III funds. As a result, a large number of UCITS funds were expeditiously migrated into the new UCITS III regime within a short space of time. This is an achievement that we both should be very proud of. In fact, I was told that other Asian jurisdictions quickly replicated our interim measures. Once the application of these measures got into full swing, we quickly issued streamlined measures (in March 2007) to facilitate the processing of

UCITS III funds with special features, eg, funds using financial derivative instruments and incorporating appropriate risk control mechanisms.

Where products do not strictly comply with all UT Code requirements, waivers may be sought under the UT Code. We grant these waivers through the Committee of Units Trusts set up under the UT Code. The Committee comprises Commission staff and market representatives from various disciplines, such as fund management, trusteeship, and academia. These members bring to the Committee market wisdom and expertise and a diversity of perspectives.

Many of the new and innovative products that you have seen in the last several years have in fact been authorized under this waiver gateway. Of course, we would not have been able to authorize these new products had we not had the willingness of the industry to work together with us, they putting in the creativity and we providing the intellectual regulatory support. Let me illustrate with a few examples how this partnership worked.

A-share index tracking fund

Today, retail investors are familiar with the various index tracking funds available in the market, many tracking markets otherwise difficult for retail investors to access. These funds can be traced back to 2004, when we authorized the first exchange traded fund that tracked the China A-share market. As a result of our ability to open up this space, we laid the foundation for other index tracking funds that provide exposures to markets that are otherwise not readily and directly accessible because of legal or regulatory restrictions.

There were some special features about this first A-share tracking ETF which made it non compliant with requirements under the UT Code. Because of restrictions, the fund is structured to achieve exposure to the relevant A-share index only through 100% investment in equity-linked instruments issued by one specific financial institution. Such exclusive investment in the papers issued by one single financial institution does not comply with the UT Code. Through the Committee on Unit Trusts, we were able to grant a waiver from this requirement taking into account factors such as the legal constraints on investing directly in the A-Share market, the reputation of the issuer of the equity-linked instruments, the enhanced disclosure made in the offering document, and the criteria for selecting the issuer of the equity-linked instruments.

As I said, this has paved the way for the authorization of other ETFs. These include, for instance, ETFs tracking other emerging markets such as India.

Actively managed closed-ended fund

In May 2007, we authorized the first actively managed listed closed-ended fund that invested in the A-share market. Since the fund is listed, it does not provide any redemption facility as in the case of other open-ended funds authorized by the Commission. Technically speaking, this fund does not comply with the UT Code requirement on dealing frequency. A waiver was necessary if this fund was to be authorized and listed. We (through the Committee on Unit Trusts) took the view that the listing platform of the HK Stock Exchange Main Board would effectively provide the equivalence of a regular (in fact daily) dealing facility and liquidity for investors. Using overseas examples as a guide, we secured the agreement of the issuer to provide additional safeguards in respect of the replacement of manager, change of investment policy, de-listing or de-authorization, and issue of new units. The issuer also undertook to conduct extensive investor education in the product. With that we cleared the way for the fund to list, thus giving investors here an additional vehicle to invest in the China A-share market.

First commodities futures index tracking ETF

In late 2007, we authorized the first commodities futures index tracking ETF. The objective of this fund is to track the performance of a long-established and most widely followed index of commodities futures. The fund complies with all relevant requirements of the UT Code, except for the fact that it tracks a commodities futures index, but the UT Code envisages only equities, debts or other securities indices.

Again, we had to examine if a waiver should be granted. Through the Committee on Unit Trusts, we noted that while the Code has specified certain types of indices that a fund may track, these could not have been exhaustive as the Code has also laid down the guiding principles for the identification of an index for tracking. As the commodities futures index in question satisfied the guiding principles on acceptable indices, we were able to grant a waiver. Given the novelty of the index to Hong Kong retail investors, we worked out an agreement with the issuer on enhanced disclosure of the fund to provide investors sufficient information on the fund, the index and the attendant risks. We also worked alongside the issuer on an investor education blitz on commodity indices investments. With that, our first commodities futures index tracking ETF was born.

Rationale for UT Code Revision

We have set as part of our work plan for 2008 the task of conducting a comprehensive review of the UT Code, together with the current RJS and AIR schemes. The objective is to revamp and modernise the UT Code, to make it a Code for All Seasons.

Why review, and why now? Market innovation and financial technology have charged ahead with full force. Elsewhere regulators have conducted or are conducting their own reforms and modernization. EU Regulators are completing the harmonisation of laws throughout Europe, adopting the new UCITS III directive in Dec 2001, and fully implementing the directive in February 2007. The UCITS III directive provides new avenues for the use of sophisticated financial instruments to the extent that such activity is well supported by appropriate risk control mechanisms. The UK Financial Services Authority also reformed its regulation of collective investment schemes in mid 2003 and produced a new CIS sourcebook to provide a more flexible regulatory framework. The Financial Services Agency of Japan undertook a major overhaul of the rules that govern the financial and capital markets and rolled out the new legislative framework under the Financial Instruments and Exchange Law in September 2007, in response to the globalization of the financial market and the development in financial technologies.

I believe the time has come for Hong Kong to take a lead in this part of the world in taking a holistic and purposeful look at its current platform. The UT Code was written just as the Asian Financial Crisis began to unfold. The market innovation and technological breakthroughs in the size, scale and speed that we know today were not on the radar at that time. While we have skilfully crafted and deftly applied the UT Code to enable the new products of today, we deserve a new UT Code that could take us to the next level and beyond.

We want to remove all impediments to growth and innovation, and infuse the UT Code with new flexibilities to ensure that we stay in lockstep with the best and brightest of financial innovations. Against the market's insatiable appetite for better and more services and products at lower costs, we must meet these demands to stay ahead of the competition.

As you know, our asset management industry has reported very impressive double digit growth in each of the last five years (total AUM of US$789 billion as at end 2006 compared to US$378 billion as at end 2003; see FMAS reports issued by the SFC in years 2004 to 2007). Not only this, Hong Kong has been drawing increasing numbers of fund managers, attracted no doubt by the depth and breadth of our market, the transparent and customer-focused approach of our regulation, and the enormous opportunities in mainland China, the needs of which Hong Kong is in a unique position to serve. In the last two years alone, we have granted 130 new fund manager licences and authorised 480 new fund products. Our retail fund platform has attracted not just local investors but also investors from the region. As mainland liquidity seeks investment products overseas and mainland managers seek skills outside the mainland border, we have the ability to become the fund supermarket in Asia, serving both the mainland and other parts of this region. We must therefore revamp the UT Code to make it even easier for funds and talents to congregate in Hong Kong.

What will the new UT Code look like?

In our review, we will be open-minded. We will listen very carefully to your views and ideas. We want a code that works for everybody – as I said, a Code for All Seasons.

I don't know what you will be telling us as we go into our different rounds of consultation. I promise you that we will listen most attentively. But I can tell you now that I envisage the new Code will have the following building blocks:

- It will be principles-based, to provide for flexibility and scalability to accommodate growth. We will avoid prescriptive measures, unless they are necessary to illustrate how a principle could work.
- It will not attempt to restrict funds to any rigid asset classes or investment structures. There will be guiding investment principles in line with international standards and practices. The market will decide if your fund is suitable, on the basis of proper disclosures, demonstration of relevant skills and proper rules for valuation, risk management, fiduciary obligations and operational safeguards.
- But the fundamental investor protection tenets will remain, such as the requirement for segregation of custody from management.

In regulation, we must balance market development with investor protection and market integrity. As always, the imperatives of maintaining standards that are on a par with those of other leading international financial markets and of attracting and retaining quality market players and investors remain. As we give to the market more room for innovation, we must at the same time step up our investor education efforts so that investors understand what the regulator can do for them and what they must do for themselves, which is to understand their responsibilities and the risks when investing in new and complex products.

Way ahead

As a start, I hope to set up several workgroups within the next month, so that discussions can commence before the summer sets in when managers take time off. The workgroups will comprise market practitioners from the relevant disciplines. In these workgroups we will study in detail the core areas, such as investments and disclosures. Discussions at the workgroups will identify issues for review and generate new ideas for consideration. They will also provide an interactive forum for the sharing of experience gained in overseas jurisdictions.

In these work groups we also hope to examine the current AIR and RJS schemes, and explore how these schemes could be strengthened and broadened in Hong Kong's best interest. Once we reach a collective view on this, I hope to start engaging overseas regulators to commence discussions on these areas. This work can go on in parallel with the UT Code review.

Meanwhile, barring unforeseen circumstances, I aim to conclude discussions at the workgroup level by Q3 this year. The issues discussed at the workgroups will be examined and analyzed within the Commission, and further research will be conducted where necessary. I envisage that this will culminate in a model which we will bring back to the industry for a round of soft consultation during Q4 this year. This step allows us to assess whether in the real world of fund management our proposals would work and have relevance. The soft consultation net should be cast widely so that different market segments could give us their input, and that we could debug the proposals. Once we have completed this process, we will conduct a public consultation on the proposed new UT Code in Q1 2009. I expect the new UT Code to be firmly in place sometime in 2009.

You are familiar with our consultation process. You have made valuable contributions before, and I am hoping that this time you will commit time and resources to help us get the new UT Code right. That will be the single most important blueprint for our fund management industry going forward.

I look forward to your partnership as we start this important journey.