The Art of Indexing Summit Asia 2010

Keynote Address

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8 June 2010

Ladies and gentlemen, good morning. It's a pleasure to be here today.

Introduction: regulatory developments

I've been asked to give a regulatory perspective on exchange-traded funds (ETFs). It's a timely request not just because of the current regulatory reform proposals in various jurisdictions, some of which will affect ETFs, but also because exchange-traded and index funds comprise one of the fast-developing segments of our markets. In Hong Kong, as in many other places, we've seen significant changes in the number and types of funds that are being offered in the last few years.

We first published guidelines on index funds in April 2003. Things have come a long way since then!

As some of you will be aware, in Hong Kong we have revisited aspects of our Code on Unit Trusts and Mutual Funds. Some of the changes we've made reflect the growth and innovation we're seeing in the index fund market. Collective investment schemes require the Hong Kong Securities and Futures Commission's (SFC) authorization if they are to be offered to the public in Hong Kong. We have made some modifications to our requirements for authorization of index funds, codifying our practices in relation to funds employing representative sampling or synthetic replication to track indices or benchmarks and reflecting the fact that we are now seeing ETFs tracking many different asset classes.

The revisions we made to the Unit Trusts Code resulted from a broader review of our regulatory regime for products and of our code of conduct applicable to persons licensed by or registered with the Commission. Our reform proposals were not just aimed at accommodating market developments in certain areas but also to address issues identified as a result of the financial crisis and the failure of Lehman Brothers. The various proposals were published for public consultation in 2009. We published our conclusions in respect of that consultation on 28 May, along with revised product and conduct codes. Following gazettal, the changes will become effective over the next few months pursuant to transitional arrangements.

I note here that the Singapore Monetary Authority has also recently released a consultation in respect of proposed amendments to the Code on Collective Investment Schemes. There are many similarities between Hong Kong and Singapore, not least the fact that they are both open, international markets in Asia. We will follow the progress of Singapore Monetary Authority's consultation with interest.

The Hong Kong ETF market

By way of background, perhaps I can provide some general information on the Hong Kong ETF market.

As of May 2010, there were 62 ETFs listed in Hong Kong, and 38 of these were cross-listed in other jurisdictions. Hong Kong is the second-largest market in Asia for exchange-traded funds. This is both in terms of turnover (where we rank second to Mainland China) and in terms of aggregate market capitalization of ETFs (where we rank second to Japan). In 2009, average daily turnover for ETFs increased by 13% from levels in 2008. For the first four months of 2010, turnover for ETFs as a percentage of total turnover on the Hong Kong Stock Exchange was just shy of 3%.

As is the case in many parts of the world, we're seeing ever-increasing numbers and types of ETFs being offered in our market. Hong Kong has ETFs linked to equities, bonds, commodities and gold, an interest rate-linked ETF and ETFs focusing on regional, single-country and sectoral indices.

There is much appetite for funds tracking Mainland Chinese benchmarks in particular. Hong Kong saw its first ETF tracking the China A-share market (the iShares FTSE/Xinhua A50 China Tracker) in 2004. This was the first ETF in the world to offer investors outside Mainland China access to the A-share market in China. In terms of assets under management, this fund is still the largest ETF in the Asia-Pacific region, excluding Japan. In January we saw the listing of the first ETF in Hong Kong tracking a Shenzhen Stock Exchange index. This was also the first ETF managed by the Hong Kong subsidiary of a Chinese Mainland financial institution.

We actively seek opportunities for our markets to grow and develop, and the ETF area is no exception. In 2009, we exchanged with the Taiwan Financial Supervisory Commission a Side Letter to our 1996 bilateral Memorandum of Understanding to provide for mutual recognition and opportunities for cross-listing of ETFs. Three Hong Kong ETFs were successfully listed on the Taiwan Stock Exchange in mid-August and, since their launch, have together constituted a large proportion of the turnover, both in volume and value, in the Taiwan ETF market. One Taiwan ETF was cross-listed in Hong Kong in August 2009.

Certainly the demand for ETFs is there. ETFs are not just the domain of the retail investor, of course. In fact, they are widely used by institutional investors as well. This has implications at the design stage, with product providers catering to a broader range of investors with increasingly diverse investment needs, and it also has implications for the way in which ETF units trade in the secondary market. I will touch on this second point a little later on.

Our regulatory approach

We believe that Hong Kong's interests are best served by its open-architecture approach to product offerings. We believe that investors should be able to make their own choices from a broad range of investment products. We therefore encourage growth, innovation and healthy competition in our markets. It is, however, important to strike the right balance between facilitating market development and providing an appropriate level of protection for investors' interests. I'd like to focus in particular on index-tracking funds seeking our authorization for public distribution, and on what our primary considerations are for their underlying indices.

Indices

From an ETF provider's perspective, the fund's underlying exposure needs to appeal to the intended target market. It could be a broad-based, diversified ETF. It could be a much more narrowly-focused ETF, or one employing a specific strategy. Great care needs to be taken in choosing – or building – an appropriate index.

Our Code on Unit Trusts and Mutual Funds contains requirements for index funds for which SFC authorization is sought. We start with the principle that the index itself must be acceptable to us. The Code then goes on to set out the criteria we generally apply when making this assessment. I'll summarize them in broad terms. The inclusion mechanism should be rules-based and impartial. Choice of components and their weightings should be consistent over time. The index objective, the market, segment, country or asset class it tracks or other exposure it seeks to provide must be clear, and it must represent or capture the performance of the relevant underlying markets, sectors or assets. The index must usually be broad-based and investible. It should be transparent, and information about the index should be readily accessible to investors. A further, very important point is independence of the index provider. We do not prohibit funds where the manager and the index provider are affiliated, provided that our requirements for objective, rules-based, transparent indices are met. However, we do require any affiliations to be disclosed, along with the means by which any potential conflicts of interest are addressed, to enable investors to assess this risk.

Disclosure

In addition to the need for robust methodologies and independent management of underlying indices, disclosure is paramount. Investors need to be given the information they need to make an informed judgment about an investment in the fund.

The buy side of the market will need to make its own judgment about the fund's coverage and how well it captures the performance of whatever market, segment, asset class or region it seeks to represent. In addition to understanding the features of the fund, and how it tracks the relevant index or benchmark, buyers should be given information about how the index is constructed, how its component securities are chosen, their weightings and liquidity, and frequency of rebalancings along with the likely market impact and cost. Other factors that affect the risk and reward profile of the fund, such as tracking risk, time horizons and other costs to the fund or to the investor, need to be clearly explained.

Counterparty risk and transparency

Counterparty risk can be another significant factor with many index funds, and this can often depend on the underlying index or benchmark. Some funds track an index or other benchmark through the use of financial derivative instruments. This may be due to the fact that physical replication of the index or benchmark is not possible. For example, a fund might seek to track a market or segment in a market with restricted access or other limitations on direct investments. Or it may be because synthetic replication might offer benefits or efficiencies for a particular structure that physical replication cannot.

In the Hong Kong market currently, out of a total of 62 SFC-authorized ETFs, 46 adopt synthetic replication.

The use of swaps and other derivatives affect the risk characteristics of an ETF, and can limit transparency. The revisions we made to our Code on Unit Trusts and Mutual Funds this year include detailed requirements for authorized funds using these sorts of instruments to achieve their investment objectives. These cover things like the credit quality and independence of the issuers of the instruments, valuation of financial derivative instruments, limits on counterparty exposures of the funds, requirements for collateral and management of collateral, and risk management and contingency planning on the part of the fund manager. The revised Code also contains specific disclosure requirements for these types of structured funds. The extra disclosure points come in addition to the general, broadly-applicable disclosure standards. Of course, we are not the only jurisdiction considering these issues. Earlier this year, the United States Securities and Exchange Commission (SEC) indicated that it planned to review the use of derivatives by ETFs, mutual funds and other investment companies. The specific requirements that we put into the revised Code are in essence the body of practice that we developed over the last two years. As the financial crisis continued to unfold, we had to quickly devise measures to help those of our funds that used synthetic replications to manage down their counterparty exposures, bring in liquid, enforceable collateral and fortify their contingency planning.

Other implications of the wide use of ETFs

I mentioned earlier that the increasing use of ETFs by both retail and institutional investors has implications for the secondary market in these products. Much is made of the convenience of ETFs, of course, that they trade like stocks. Naturally, then, they can be subject to the same market effects as other exchange-traded products. Perhaps the most acute example was the 6 May market disruption in the United States. Mary Schapiro, Chairman of the United States SEC, in her testimony before the US Senate Securities, Insurance and Investment Subcommittee on 20 May, specifically referred to the precipitous declines experienced in ETFs on 6 May. She noted that ETFs constituted about 70% of the US-listed stocks in which trades were cancelled by the exchanges due to price declines of 60% or more away from their levels just prior to the huge drop on that day. She indicated that the SEC continues to investigate matters that may have contributed to this. Areas of focus include the linkages between the declines in the ETF market and the equity market and the roles of market makers and authorized participants, as well as more technical factors such as the operation of the “trade-through” rule under Regulation National Market System. Chairman Schapiro noted in her testimony that institutional investors use ETFs to acquire or eliminate certain market exposures, and indicated that the SEC was focusing on whether this strategy may have led to substantial selling pressure on ETFs during the steep market decline. She also stated that the SEC would explore whether short selling of ETFs by institutional investors may have contributed to price swings in ETFs on that day.

Clearly, then, the appeal of ETFs to a wide range of investors and their use in a variety of different trading strategies have implications not just for the behaviour of ETF prices themselves but also for the broader markets, given ETFs’ linkages to underlying assets. Markets are global. Investors have a choice not just of products but also of markets and where they wish to trade. Our ETFs have a very strong institutional following. As such we will be closely following the SEC's investigations.

I’m conscious that I’ve sought to cover quite a bit of ground in a short space of time, so I will conclude here.