Ladies and gentlemen,

I would like to thank ICBI for inviting me to speak to you today.

**Retail fund industry in Hong Kong**

Investment funds are one of the most popular investment vehicles for the Hong Kong retail investors. According to data released by the HKIFA, as at end 2006, 20% of Hong Kong’s adult population invested in investment funds. The SFC has authorised nearly 2,000 unit trusts and mutual funds for offering to the public. We also see more new fund management groups from places such as UK, France, Australia and Switzerland, who have shown interest in bringing their products to Hong Kong. In addition to the rapidly increasing number of funds, there has also been a corresponding increase in the types of investment products available to the retail public in the past few years. In today’s talk, I would like to review briefly our efforts in shaping our regulatory framework to facilitate development in the asset management industry, and outline some recent initiatives.

**Guaranteed Funds and Hedge Funds**

The low interest rate environment and the downturn in major equity markets a few years ago prompted a major demand for new investment opportunities. In response to such demand, we started a series of initiatives to facilitate product development. As a first step, we enhanced our authorisation regime for guaranteed funds in 2002, and established a framework for the authorisation of retail hedge funds.

We have since witnessed substantial growth in the volume and variety of guaranteed products over the years. The asset management industry has expanded its investor base. Product distributors and retail banks have developed a major source of non-interest income from wealth management business for retail investors. Investors have easy access to a wide variety of underlying asset classes packaged with innovative risk return profiles.

Turning to hedge funds, Hong Kong is one of the very first jurisdictions in the world to allow the sale of hedge funds to the retail public. This also marked our effort to deregulate rules that inhibit competition and innovation in the fund management industry. Our regulatory framework for retail hedge funds provides a good example of how we seek to strike the right balance between giving investors sufficient access to appropriate investment choices while ensuring a proper level of investor protection. We have a multi-pronged approach in discharging our role as a gatekeeper:
First, we assess the acceptability of the hedge fund manager.
Secondly, we ensure adequate structural safeguards and proper disclosure in the fund set-up. We adopt a market segmentation approach via minimum subscription thresholds for different types of hedge funds.
Thirdly, we encourage the industry to offer more investor education.

There are now 14 retail hedge funds authorised by the SFC with a total net asset value of over USD1.6 billion at the end of 2006. Although the size of authorised hedge funds is relatively small in the context of the whole retail funds universe, the introduction of retail hedge funds does provide investors with an access to a wider range of investment choices.

**REIT market**

To further reinforce Hong Kong’s leading position as an international financial hub, we introduced a regime for the authorisation of REITs. This was a significant milestone in the development of a new type of investment expertise and a new asset class in the continuing diversification of our financial markets.

While REITs have over twenty years of history in Australia and the US, they constitute a fairly new asset class in Asia and we are likely to experience fast development in REITs in the region, both in terms of magnitude and diversification. We therefore need to remain mindful of the development of REITs in the international arena and to apply our rules in a pragmatic manner to deal with issues as they arise, while bearing in mind protection of investors’ interest.

In June 2005, the SFC revised the REIT Code to allow investments in overseas properties. Further, to provide REITs with sufficient financial flexibility and better management of currency exposure in the case of overseas investments, the permitted gearing ratio of REITs has been raised from 35% to 45% of total assets. This gearing level has been arrived at after consultation with the public and market practitioners, as well as examination of the development of cross-border REITs in overseas jurisdictions.

Given the limited size of Hong Kong and the fact that most of the properties that are of investment grade are already listed on the Hong Kong Stock Exchange, the opening up of overseas investment significantly enhances the development prospects of the Hong Kong REIT market. Hong Kong can, as a result, provide a platform for the listing of REITs that invest in properties in the region, thus broadening the investment choices and attracting participation of international investors. In fact, the lifting of geographical restriction was crucial in enabling the listing in Hong Kong of the first REIT in the world with 100% exposure to Mainland properties at the end of 2005.

The listing of the Link REIT, the first REIT in Hong Kong, is so far the largest REIT IPO in the world. To date, six REITs managed by SFC licensed corporations in Hong Kong have been successfully launched and listed on the Hong Kong Stock Exchange. The REIT market in Hong Kong offers investors a wide choice of properties, including retail properties, commercial properties in decentralised locations in Hong Kong, Grade A offices in Hong Kong, and properties in mainland China. At the end of March 2007, we also saw the listing of the first hotel
REIT in Hong Kong. In addition to substantial interest at the time of the IPO, an active secondary market has developed among REITs.

Hong Kong is a small place and we already have a substantial universe of listed real estate assets in the form of listed property companies. A significant part of the growth of the REIT market will be through the process of overseas investments by REITs in Hong Kong.

In addition to our vast hinterland of the Mainland, another strong source of growth to the Hong Kong REIT market is expected to come from elsewhere in Asia. As Asian real estate markets open up in the coming years due to rapid urbanization, strong economic growth and the increasing presence of foreign institutional investors, the Asian market will constitute a potent force in the development of REITs in Hong Kong. Scale funding has to be obtained and REITs offer an attractive means to property owners to liquidate their holdings to fund further development projects.

We are committed to facilitating the development of REITs with Asian real estate exposure. So far, aside from The Link REIT, all the REITs listed in Hong Kong are spin-offs of properties owned by property companies already listed in Hong Kong, and the REIT managers are seasoned local property portfolio managers. While we are encouraged to see the development of local expertise in REIT management, we very much like to see and welcome international professional asset managers to package their real estate investments into REITs for listing in Hong Kong.

Our aspiration is for the Hong Kong REIT market to attract not just assets already listed in the portfolio of Hong Kong listed companies, but a new universe of quality real estate assets in the region, managed by internationally renowned houses, as in the case of the more developed REIT markets of Australia and the US.

We very much hope and would like to see a broad range of REIT products with mixed portfolios of local, Mainland and other overseas assets coming to the Hong Kong market. This will add to the depth and breadth of our REIT market. We believe a congregation of home-grown and international REIT managers with diverse backgrounds will facilitate transfer of technical know-how and expedite the further development of REIT management expertise in Hong Kong.

UCITS III funds

I would now like to say something about the implementation of the new UCITS III scheme. In Hong Kong, over 70% of our retail funds are UCITS funds and the SFC welcomes the added flexibility provided by the UCITS III regulations. However, in order to facilitate the conversion and authorisation of the 1,300+ UCITS III funds, the SFC needed to work very closely with the industry and issued interim measures in March 2005 that set out practical and concise requirements for all UCITS funds seeking authorisation by the SFC from Luxembourg, Ireland and the UK.

Today, we are glad to see that many UCITS funds have successfully migrated to UCITS III under this measure.
Despite the successful migration, we are aware that more fund houses wish to use financial derivative instruments and create innovative products and specialised schemes that are now permissible under the UCITS III legislation. This imposes higher demands on the fund manager’s risk management process and controls systems.

To help fund managers and practitioners understand what is expected of them when utilising the expanded investment powers of those UCITS III funds, the SFC has issued a guide that sets out the kinds of information relating to risk management and the control process that should be provided to the SFC in support of their application. Such information include the risk management procedures put in place by the fund manager to monitor, measure and manage the relevant risks in relation to each UCITS III fund. In the future, we would urge the Hong Kong office of the UCITS fund managers to help in communicating the Hong Kong regulatory requirements to their home offices, so as to ensure that both the home and host requirements are observed by UCITS funds.

Funds with special and innovative features are always given a fair hearing by the SFC provided they comply with the necessary requirements. We do accommodate innovative UCITS III products and, in this regard, we issued streamlined measures in March 2007 for processing UCITS III with special features. To date, we have approved a number of UCITS III funds with special features e.g. guaranteed funds and funds of funds.

ETFs

In 2003, we published guidelines for regulating index tracking Exchange Traded Funds. In June 2005, the SFC authorised the first bond index-tracking ETFs in Asia under the Asian Bond Fund (ABF) 2 project. We also authorised the first ETF in the world to offer non-Mainland investors access to China A-shares market.

To facilitate product innovation, we have recently authorised a commodity ETF. The ETF tracks the CRB Index, and is to be listed on the Hong Kong Stock Exchange. Our Code on Unit Trusts and Mutual Funds provides an authorisation regime for index funds which tracks indices on equities, debts or other securities. ETFs tracking commodity indices are not explicitly catered for in our Code. Nevertheless, we are open to consider product innovations on a case by case basis and to adapt our authorisation requirements to new products. We welcome new product ideas from the market, and we would endeavour to work with the industry to explore appropriate structures and mechanisms to give retail investors access to the latest investment technology.

China Opportunities

Mainland China is an important focus in the financial world today. The Mainland’s domestic Shanghai A-share market surged 170% from January 2006 to March 2007, and the Shenzhen A-share market surged 192% during the same period. The Mainland government has opened up its financial markets to foreign investors through the QFII scheme, which allows Qualified Foreign Institutional Investors to invest in Mainland securities. By obtaining QFII status, Hong Kong asset management companies can directly play the China securities market. In June 2006, the SFC authorised the first equity fund that invests directly in China A-shares via the fund
manager’s own QFII quota. A number of retail funds with significant exposure to A-shares have since been authorised.

In addition, the Mainland has granted more than USD13bn QDII quota to Qualified Domestic Institutional Investors to invest overseas. Although QDII offer notable investment opportunities for Mainland investors, the take up rate has been slow. As at the end of December 2006, a total of USD 13.6bn quota was granted to approved QDIIs, of which USD13.1bn was granted to 15 bank QDIIs. However, the actual investment in QDII products totalled less than USD400m. The remaining USD0.5bn was granted to a Mainland based asset management company.

Bank QDII products are not doing as well probably due to (i) the 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 authorised funds that invest in H shares listed in Hong Kong).

In April 2007, the SFC signed an MOU with the CBRC for cooperation and information sharing with respect to Hong Kong licensed intermediaries who provide services to Mainland commercial banks conducting overseas wealth management business on behalf of their clients. The MOU establishes an information sharing and cooperation platform between the SFC and CBRC. This will enable Hong Kong to play an active role in the development of the overseas wealth management business of Mainland commercial banks.

Further initiatives

We are committed to pragmatically applying the principles embodied in the relevant product codes to the regulation of products, while at the same time addressing the imperative of providing appropriate investor protection. This is achieved through a two-pronged approach. On the one hand, the SFC ensures the market’s awareness of its policy and practices through the establishment of codes and guidelines, and issuance of FAQs and circulars. On the other hand, the SFC keeps abreast of market development by maintaining ongoing dialogues with industry players and staying alert to new trends and developments in the market.

Let me now briefly mention some of the initiatives we are taking to further facilitate market development. We have set up a working group with representatives of the industry and the HKIFA to review the existing advertising guidelines in the Code on Unit Trusts and Mutual Funds and to consider the possibility of streamlining the authorisation process of marketing materials of SFC-authorised retail funds. In short, we recognize that the current practice of detail vetting of all marketing materials of SFC funds could impose a regulatory and cost burden on the market. We want to examine, with the help of the industry, how this burden could be alleviated.
Separately, we have engaged an external consultant to study the retail funds authorisation regime and processes in overseas jurisdictions. The consultant’s report will give the SFC a good compass to benchmark the Hong Kong authorisation regime and determine the areas for further review or alignment. Again, the purpose is to examine if our current processes and requirements are appropriate in the bigger picture of Hong Kong’s role as an asset management hub in Asia.

Conclusion

We aim to maintain a regulatory framework of international standards and market integrity. In doing so, we have a dual role of facilitating market developments while upholding investor protection and the reputation of Hong Kong as an international financial centre. We hope to attract quality market participants, which will in turn facilitate the growth of the overall market. As new investment technologies bring an expanding range of investment opportunities with increasing sophistication, we would endeavour to provide an environment conducive to product development. In this regard, we will continue to maintain close dialogue with the industry, and to shape our regulations to enable Hong Kong to continue to grow as Asia’s premier fund management centre.

Thank you.