Good afternoon ladies and gentlemen.

First let me thank the HKIFA for inviting me here today.

Financial Market Turmoil but Fund Industry held up well

I had the pleasure of speaking to you last April and I remember inviting you all to capture the growth opportunities from the Mainland. It has been less than a year, but since our last meeting, the world financial markets were knocked over by a near “perfect storm”. Over the last few tumultuous months, many of you have told me that it required all your skill, experience and courage to steer your firm through the financial tempest, all the while trying to sense when the next storm is coming.

Thankfully, however dark the clouds, there are still glimmers of light amidst the gloom. The financial figures for the fund management industry for 2008 are one of those shafts of golden light. The number of firms licensed for asset management in Hong Kong has actually grown by no less than 17% between end 2007 and end 2008. In addition to about 100 newly licensed asset management firms, 17 licensed firms added asset management to their licensing status during 2008. The number of authorised unit trusts and mutual funds as at end December 2008 stood at 2218, representing a modest but still respectable growth of 8.7%. More impressively, the average daily turnover of exchange-traded funds for 2008 hit a record high of HK$1,800 million, showing a 176% increase from that of the previous year. In 2008, the volume of our ETF trading surpassed Japan’s and placed us at the number one position for the whole of Asia.

Now I need to qualify these numbers. I understand that many of you have seen a significant reduction of your AUM and to a large degree, this is caused by a plunge in the markets in which your funds are invested. This is certainly true, as the Hang Seng has dropped 48% and the Dow recorded a 34% decline for the year. The latest figures from the HKIFA Sales and Redemptions Survey indicate that in the period of January through November 2008, gross retail sales of funds dropped by a massive 83.7%, while redemptions increased significantly. As a result, net retail sales turned from a positive US$117.63 million in January to a negative US$250.91 million by November last year.

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1 Internal figure from Investment Products Department.
2 HKEX figures.
3 Figures from SFC Research Department, HKEx and Reuters.
Many investors continue to be risk averse, choosing to stay on the sidelines. The world has not been the same after the collapse of Lehman Brothers and accepted dogmas have been overturned and cast aside. So, while the numbers for the whole of 2008 may still look marginally positive, they mask the very steep and worrying declines recorded in the last quarter of 2008.

But what is important to note is that the Hong Kong fund management industry has held up very well. Despite significant retrenchments in the markets and heavy redemptions, SFC authorized funds have continued to operate smoothly. Of the 2,218 authorized funds, all but 4 have continued to allow trading and redemptions. As for these 4 funds, they have invested in bonds in emerging markets and are facing liquidity problems, or in the process of winding-up and returning assets to investors. There has been no disorder or panic.

The remarkable resilience of our fund management industry underscores that we have been successful in two areas: first, we have attracted and retained the best talents – our fund managers have the professionalism and skills to stay afloat in the most stormy of waters; second, we have built and maintained a robust regulatory framework that has helped the industry hold itself together. The continued health of our fund managers is a top priority.

**Our Regulatory Platform for Funds**

Over the last year, and especially during the last quarter of 2008, we stayed in close contact with our fund managers. This was both necessary and useful as it helped us monitor how Hong Kong based funds fared during the crisis, which in turn helped us fashion prompt regulatory responses to any looming problems. In addition, through this close communication, we were able to share with fund managers any market-wide information or trends that we detected and which fund managers would find useful in helping them to avert difficulties. Let me cite one example. In November 2008, as the crisis engulfing the US auto industry gathered pace, we were able to quickly ascertain that none of our funds had an exposure to the auto companies by more than a very low single digit percentage of their assets. This immediately removed any fear or panic that might otherwise have plagued the industry or affected investor confidence in the funds.

I strongly believe that regulators and market players must work together as a team if we are to help the industry to come out of this crisis in reasonable shape. We cannot do it alone. Your help is essential and very much needed. What regulators can do is set out the expected standards, rules and parameters for the market to carry on its business activities. You are the active players.

You see, when an investor invests in a fund, he entrusts to the fund manager discretionary management of his money, within defined parameters. To be worthy of this trust, a fund manager must have the highest integrity, and must bring to the table a potent combination of talent, skill and sound professional judgment. Following this philosophy, our fund regulation platform is built on three principles:

1. The fund manager must be licensed (either in Hong Kong or in a jurisdiction that is acceptable in our Code on Unit Trusts and Mutual Funds), and must have the requisite skill and competence.
2. The fund must diversify its investments and typically no investment in a single issuer can exceed 10% of the fund’s NAV.

3. The fund’s assets must be separately held by a trustee/custodian whose duties include verifying that a fund manager’s investment decisions are within the fund’s investment parameters, and that the investments are kept outside the reach of the fund manager.

These principles have served Hong Kong well, keeping the fund management industry growing and intact in the last 20 years despite several market crises.

**SFC’s Efforts to help the Fund Industry rebuild Investor Confidence**

Stung and hurt by a seemingly endless string of headline events that continues to shock global financial markets, investors are beginning to lose faith in the markets. After the Lehman failure, investor confidence across different types of investment products, be it funds or otherwise, became even more fragile. The point I wish to make here is that a loss of confidence in one type of investment product, say the controversial Lehman minibonds, is capable of tarring all investments products with the same brush. Which is to say, investors may lose their appetite and confidence in all types of investment products, however sound their fundamentals and benefits are, due to perceived failings of just one product.

In Q4 2008 for example, we saw a marked reduction of fund applications coming to the SFC. We received a total of only 91 new applications during the period 16 September through 31 December 2008 (down 36% from the same period in 2007 and on an average monthly basis 58% less than the average monthly figure for the period 1 January through 15 September 2008). This, we are told by a good number of fund managers and distributors, reflects the lack of investor interest and the weakness in the market post Lehman Brothers. With the exception of perhaps guaranteed funds, investors appear to be branding all funds, irrespective of their risk profile, as risky investments.

Many who bought Lehman related structured products complained that they did not understand the risks of the products that they had bought, that they had not fully understood the product documents and the risk disclosures therein, and that they had been mis-sold. Although none of our authorized funds had been involved in these products, we believe that our fund managers should nevertheless take particular heed of the needs of investors in this difficult investment climate. Fund managers should respond positively by showing that they care about investors’ concerns.

With this in mind, I would like to talk about a circular which we issued to the industry on 5 December 2008. The primary objective behind the circular is to invite the fund industry to further enhance product disclosure to help investors understand what it is they are actually investing in, and what are the key risks. Both before and after the circular was issued, my team and I held meetings with the HKIFA to discuss how the fund industry could incorporate these disclosures to help investors, and why these are necessary.

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4 The number of applications between 16 September through 31 December 2007 was 143. The total number of applications from 1 January 2008 to 15 September 2008 was 521.
Frankly speaking, not every fund manager agreed with this approach, at least not initially. Some of you questioned the necessity of these enhanced disclosure requirements, pointing out that funds have not caused any problems. I can understand that at a time when demand is weak and margins are squeezed, these requirements appear to make your business burden heavier. I have tried to explain the logic to individual fund managers, but let me take this opportunity to explain it to all of you.

Many of you here will be aware that the circular set out a tentative format (to be used in marketing materials and offering documents) whereby the key features and risks of a fund will be written up prominently on the cover page. This is done to make sure that the information presented catches the investor’s attention. The disclosures also remind investors that they should invest in the product only if they have been advised that it is suitable for them. These key features and risks are already contained in the offering documents and the obligation to ensure suitability of a product for an investor is part of the existing regulatory framework. So all we are trying to do is to make sure that this very important information is placed upfront and in sharp relief so that investors would be better able to make informed investment decisions.

Many of you have an excellent track record and will doubtlessly continue to do well in the future. But now is the time to show investors that you understand their concerns, and you are willing to walk the extra mile to give them the information they need and in a manner that makes it easier for them to appreciate and understand. I hope you can appreciate where we are coming from, as we need your help on this issue.

In the period 16 September through 31 December 2008, we authorized 82 new funds. While 9 of these were authorised before we worked out the enhanced disclosure requirements, 73 were authorized with these enhanced disclosure requirements in place. To me, this amply demonstrates that many of you are serious about branding yourselves as trusted partners to your investors.

These enhanced disclosure requirements should not be confined to the documents and marketing materials of new funds. They should also apply to the marketing materials that continue to be used for existing funds. You are certainly justified in asking us for a little longer lead time for putting these disclosures on marketing materials of existing funds, given the volume involved. As you know, we have agreed to give everyone an extension of time until 31 March 2009 to get this done. For those who anticipate they may still have problem meeting this deadline, we are prepared to grant yet another extension of up to another 3 months, provided they have good reasons.

When I said that we need your help, I do mean it. I have invited the HKIFA to volunteer a few industry representatives to work with us to examine different types of marketing materials to identify the appropriate enhanced disclosures to be applied to each of them. I envisage that while printed advertisements and distribution pamphlets should carry these enhanced disclosures, other advertisements like pictures on the side of a tram, posters to be put up at bus stops, etc. may be treated differently.
As banks and hedge funds continue to report huge losses, and when money market funds threaten to fail, regaining investor confidence becomes a key global priority. Improving transparency of products through these enhanced disclosure requirements is a key building block towards that exercise. As your regulator, I pledge to work together with you towards achieving this goal.

**Fund Industry Development – “back to basics”**

In the years running up to mid 2008, the appetite was for high yield, emerging markets and structured derivatives. Today, it looks like a case of “back to basics”.

More traditional, simpler investment products, i.e., the plain vanilla, no-frills products which were once disregarded as lacking sophistication and almost forgotten in an era of burgeoning exotic products, are gaining traction once again.

People like products that are easy to read about. People derive comfort in buying products that they understand. Simpler products also mean that issuers do not have to scratch their heads over how to simplify and explain the product’s features and risks to their clients.

Hong Kong investors need to invest – for a better life style, for children’s education and for retirement. By 2025 Hong Kong will have a disproportionately large population of people over 65 years old. We have one of the lowest fertility rates in the world, at a rate of 1.02% in 2007.\(^5\) Hong Kong people need to save and invest for their retirement and for their future. The key is to offer what investors need.

For instance, in this economic climate, fund managers could provide value by offering products that help investors capture opportunities arising from a bear market. I am heartened to report that we are now looking at some innovative products. For example, one new product we are currently processing is an inverse / short ETF. Such a product, if properly understood and used by investors, could capture opportunities resulting from the downside of the market. ETFs are transparent, the methodologies used for tracking are well tested, and the Hong Kong market has the depth and the liquidity. We are also considering a new fund that seeks to take advantage of the current steep discount in the pricing of investment and non investment grade corporate bonds. Unlike listed shares, bonds are not as directly accessible to the average retail investor. As an international financial centre, it is important for Hong Kong to continue to offer a broad and deep range of investment products.

Of course, clear risk disclosures, proper suitability advice as well as investor education is vital if we are to regain investor confidence in any kind of investment product. In terms of investor education, I would add that whenever a new product is introduced to the market, we should seek to drive home investor knowledge in that particular product, what it does, and are its risks.

**Strengthening Communication with the Industry**

As I mentioned earlier, we will soon organise intensive discussion sessions with HKIFA representatives regarding our enhanced disclosure requirements. On top of that, we will also

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\(^5\) Source: Census and Statistics Department information in 2008
discuss the revised Advertising Guidelines that came into effect on 1 January 2009. Like the enhanced disclosure requirements, we have deferred implementation of the Guidelines for the marketing materials of existing funds until 31 March 2009, and possibly to 30 June 2009 for individual cases.

Fund managers have shown exemplary compliance efforts in the past. With a wealth of collective experience, the fund industry has the necessary expertise to identify the different risks in each of their fund products. The risks of a plain vanilla fund product must be very different from those of a more complex fund. We thus expect the industry to fulfil its obligations under our revised Advertising Guidelines and enhanced disclosure requirements to its usual high standards. At the same time we are happy to provide any necessary guidance. Our upcoming discussion sessions would hopefully help clarify areas in which the industry has concerns.

As I have oftentimes said in the past, our doors and telephone lines are always open. By this I mean that a constructive, two-way dialogue between industry players and the regulator is the best way to develop the industry. In the past, you were never timid about coming up to me to share what the latest trends were, and what we should work on to open up more market prospects and opportunities for you. I would like to think that the SFC has always listened with an open mind. You will remember that it was with your help that we succeeded in opening the Mainland QDII channels. Now in these challenging times, I hope you will continue to come in to talk to us and listen with an open mind. During these difficult times in particular, we must work closely together to restore investor and market confidence.

I would like to make a further observation that fund managers and fund distributors are close partners in the entire sales exercise. Fund managers pick their distributors with care. The distributor must have the necessary knowledge, resources, competence and processes required in the selling process such that they are able to properly explain the product to the client, and to advise the client as to the suitability of the product. Please remember that in picking the right distributor, you are also indirectly helping investors make informed investment choices.

**Final Remarks**

From what the numerous experts and commentators say, the road to recovery may yet be strewn with obstacles. However, Hong Kong maintains its advantage in that it has a robust regulatory platform from which to do business, and it is a key international financial centre with well-established roots in Asia.

As storm clouds continue to gather over the major economies in the western continents, Asia, in particular the Mainland, remains a beacon of light, and hope. The overall foreign exchange reserves held by Asian countries as at December 2008 stood at a reassuring total of US$4.39 trillion. Of this sum, the largest chunk comes from China, whose foreign reserves as at end of 2008 stood at a staggering USD1.95 trillion according to the People’s Bank of China, representing a 27.34% increase from the preceding year.

Traditional savings both in the Mainland and Hong Kong are still swelling. According to the People’s Bank of China, RMB savings at the end of 2008 hit RMB 46.62 trillion, representing

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6 Reuters figures on 14 January 2009 sourced from Central Banks in Asia.
a stunning increase of 19.73% year-on-year, Hong Kong also sees a significant deposits figure of HK$5.9 trillion as at November of last year. While many of the western markets are forecasting how big a decline in growth they will see, the Mainland is still working on the assumption of around 8% growth in GDP in 2009.

We may now be at that historical moment when Asia, in particular Mainland China, stands poised to debut onto the world economic stage. As the winds of fortune hopefully start to blow east, Hong Kong must be ready to take centre stage to capture valuable opportunities as Asia exports its wealth, talent and influence. These opportunities will be a powerful engine of growth for the Hong Kong fund industry.

More importantly, Hong Kong has been and will remain the gateway to and from the Chinese Mainland. As the Mainland market continues to open, we stand to benefit from the outflow of investments and liquidity. Already, the QDIIs are primarily using the Hong Kong platform. Under CEPA IV, Mainland fund managers are setting up their subsidiaries in Hong Kong seeking suitable investment partners and opportunities. Each of these firms brings with it an enormous investor catchment in the Mainland.

On this note I would like to end by wishing all of you a Happy Chinese New Year, and a more prosperous year in the Year of the Ox.

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