

The Role of the Regulator in the Development of the Investment Management Business

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Good morning ladies and gentlemen.

Thank you for inviting me here today.

I have been asked to talk about determining the optimum balance between investor protection and industry innovation, and to examine the role that regulators can play in creating a fully fledged Asian investment management business.

This sounds like a complex topic, but if you step back and think about the issues involved, they are in fact all driving at two themes, namely, the balancing act of regulation by the Securities and Futures Commission (SFC) at the domestic front in order to promote growth in the investment management industry without compromising investor protection, and the involvement of the SFC at the international level to maintain Hong Kong as a prominent Asian investment management centre.

I would also want to share with you the findings of a theme inspection that the SFC has conducted on IPO sponsors. The purpose of the inspection was to assess the Sponsor Regime that has been in place since 2007. Being a world-leading IPO centre, Hong Kong needs to ensure sponsors perform their functions to a high standard. The findings have provided important insights into possible ways to enhance investor protection in relation to IPO activities.

Hong Kong as a pre-eminent Asian investment management centre

A few pieces of data best capture the state of the financial industry in Hong Kong.

Growth in fund sales

According to statistics issued by the Hong Kong Investment Funds Association, retail funds sales in Hong Kong more than doubled in 2010 and surpassed the US\$6 billion mark in 2010. Positive performance in the financial markets has certainly contributed to this growth, however, we should not underestimate the strength of product development and promotion by industry players on the one hand, and investors' renewed confidence in fund investments on the other, as regulatory reforms that were introduced in May 2010 were understood and implemented.



Increase in number of licensees and registrants

The number of SFC licensees and registrants stood at 38,131 at the end of 2010, up about 6% from the level recorded in 2009. We have a multitude of players, not only home-grown and international firms, but also increasingly a large number of firms with Mainland background, as Hong Kong serves as the gateway for Mainland investors to invest in overseas markets.

Dominant position as an ETF centre

As at the end of February 2011, 72 exchange traded funds (ETFs) were listed in Hong Kong. According to statistics published by the Hong Kong Exchanges & Clearing Limited (Exchange), the turnover value of ETFs was US\$28.6 billion in Q4 2010, representing an 83% increase from that recorded in Q4 2009. The market value of ETFs was US\$89.2 billion in Q4 2010, representing a 40% increase from that seen in Q4 2009. According to publicly available research report, Hong Kong was the second largest ETF market in Asia in terms of assets under management and largest in terms of average daily trading volume in Q3 2010.

Increasing complexity of products

Financial innovation is a major driving force behind the growth and vibrancy of the financial market. Over the years, we have seen the development of myriad new investment instruments and strategies. Closer to home, as our ETF market augments, we have also seen a proliferation of strategies among ETFs. Synthetic ETFs use financial derivatives to replicate index performance and may be a cost-effective platform to tap a restricted market, such as Mainland China's A-share market, but they also expose investors to counterparty risks.

In an effort to raise investors' awareness of the use of synthetic strategies, the SFC introduced a new measure effective from 22 November 2010, whereby a marker X is required to be placed at the beginning of the English and Chinese stock short names of all synthetic ETFs listed on The Stock Exchange of Hong Kong (SEHK), a wholly-owned subsidiary of HKEx. The marker will make synthetic ETFs more visible on the stock pages of HKEx's securities trading system and on the HKEx website and the HKExnews website.

Building on the preceding measure, beginning 16 January 2011, managers of synthetic ETFs have been required to put an asterisk (*) and an annotation in English "(*This is a synthetic ETF)" and in Chinese, as the case may be, right after the name of a synthetic ETF whenever it appears in offering documents and marketing materials for a synthetic ETF issued by the manager or on the manager's behalf to investors in Hong Kong. Last but not least, we have also embarked on dedicated investor education efforts to help investors better understand synthetic ETFs.

Regulatory Reform

All of the foregoing has been achieved through a combination of dedication by market practitioners and the presence of a robust regulatory regime. The SFC has a vital role to play as the regulator entrusted with promoting the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry, as well as providing protection for members of the public investing in or holding financial products.



To effectively achieve these dual objectives, we must have a holistic understanding of the overall system. This means that the regulatory regime has to include the regulation of both the conduct of the intermediaries and the investment products that they sell. Further, the regulations have to be clear, transparent and forward looking so that all stakeholders fully understand them, and they can be adapted as the market evolves with new product innovations.

The Lehman Minibond crisis has also shed much light on how our regulations can be enhanced. Our investigation into the Minibond incidents has revealed that many investors 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.

Clearly, financial innovation has made some products become highly complex for the average investors to understand. It is therefore of paramount importance that issuers explain them in simple language so that investors can understand the products and the risks involved. At the same time, intermediaries have the responsibility to explain the products to their clients and assess whether the products are in fact suitable for their clients, in light of their specific circumstances.

Financial innovation, which I alluded to earlier, has also made it increasingly difficult for retail investors to understand the financial products that are offered to them. As we all know, human beings have limited cognitive resources. Therefore, whether consciously or sub-consciously, investors have a tendency to focus on things that they are familiar with, simple to comprehend, or easily accessible. They are more likely to pay attention to information that is presented in a direct and simple manner, than information that is either drafted with technical jargons or legalistic terms.

Further, when provided with an overwhelming amount of information, investors tend to feel stressed, or even confused if the issues are complex, and may end up not making a rational decision that suits their own circumstances. In extreme situations, where they are not able to discern the differences among products, they may resort to relying on information that is easy to understand, but not necessarily relevant to the decision making process, such as gifts and other promotional offers.

With all of the foregoing in mind, the SFC conducted a three-month public consultation on regulatory reforms in September 2009 and announced in May 2010 regulatory measures directed at enhancing investor protection. Our regulatory reform also prioritises the needs of investors and the maintenance of Hong Kong as Asia's leading investment management centre.

The new measures include a new consolidated products handbook, enhanced sales conduct measures and the requirement of cooling-off rights for structured products. The new measures further strengthen investor protection and ensure that Hong Kong remains a well-regulated, vibrant financial market.



SFC Product Handbook

The Products Handbook contains a set of overarching principles that will apply across the different types of products governed by the Handbook. While the Handbook contains more specific parameters for regulating each type of products that is subject to regulatory oversight by the SFC, the establishment of a set of overarching principles on a cross-product level is instrumental to the regulation of various products on a fair and equitable basis, and to prevent regulatory arbitrage.

The overarching principles relate to: acting fairly, disclosure, proper protection of assets, avoidance of conflicts of interest, regulatory compliance, diligence by product providers, and marketing of investment products. These principles serve as the guiding post for future product development, thus accommodating new financial innovation without compromising investor protection.

One of the most significant accomplishments for the investment management industry and their investors is the introduction of the requirement for product key facts statements. The genesis of this requirement is based on our belief that disclosure is useful only if it contains vital information, it is delivered in a manner understood by its investors and it does not overload investors with information to a point where they lose sight of the crucial issues. Therefore, we require that the product key facts statements summarise in simple language and a user-friendly manner, the key features and risks of investment products. The aim is to provide investors access to clear and succinct information about a product. I know that industry practitioners have been working very hard to adjust their systems to make the implementation a successful one and I truly appreciate the efforts.

Sales process and practices

Apart from the Products Handbook, we have also introduced changes in our Code of Conduct to more comprehensively outline what should be done by sellers of the products to ensure that products are offered to investors in the most suitable manner. In this regard, we have now outlined more elaborated suitability requirements, in particular, the investor characterisation requirement (a concept of characterising clients based on their knowledge of derivatives) which will come into effect in June 2011. We also restrict intermediaries from offering gifts (except for discount of fees and charges) for the purpose of promoting a specific investment product to investors.

One area that we have done a lot of work on in the regulatory reform is the issue of potential conflicts of interest arising from the fact that some distributors may have incentive to promote investment products that bring higher monetary rewards or benefits to themselves. While intermediaries are already required under the Code of Conduct to act in the best interests of their clients and to avoid conflicts of interest, it would be helpful if an investor is aware of the rewards or benefits received by the intermediary, among other factors, in order to make an informed investment decision. We have therefore introduced the requirement to disclose monetary and non-monetary benefits.

We also require Intermediaries to disclose sales related information to investors (i.e. capacity in which a distributor is acting, affiliation with product issuer, monetary and non-monetary benefits received by distributor and discount of fees and charges) prior to or at the point of



sale. All these disclosures not only further mitigate the conflict of interest issues but also enhance transparency.

Cooling-off rights

Last but not least, the regulatory reform also introduced the requirement for issuers to provide a post-sale “cooling-off” or “unwind” right for certain unlisted structured investment products to give investors a window to exit these investments. Where a client has exercised his right under the cooling-off mechanism, we require the intermediary to promptly execute the client’s instruction and pass on to the client the refund (including any sales commissions) received from the product issuer, less a reasonable administrative charge.

Global regulatory change and SFC’s role at the international level

Hong Kong is not alone in implementing regulatory reforms. At the international level, we have also seen a tide of regulatory changes, some of which have been phased in while others are still in the early stages of development. Changing dynamics are driving these changes – issues at the jurisdictional level, political agenda through the G-20 and the growth in the responsibility of the international bodies.

Paradigm shift in regulation of financial industry

As financial institutions become increasingly globalised and much financial activities are conducted on a cross border basis, we are beginning to see a shift of greater responsibility to a number of international institutions, including political bodies like the G-20 Leaders and Finance Ministers; technical bodies like International Organisation of Securities Commission (IOSCO), and accounting oversight bodies like the International Accounting Standards Committee Foundation (IASCF).

The global financial crisis further exacerbated the importance of close collaboration among regulators and standard setting bodies at the international level. This is premised on the paramount importance of systemic stability on a global basis.

As the recent financial turmoil has revealed, the globalisation of the financial industry has highlighted the importance of systemic risk regulation. This means that various markets and functions are interconnected and to properly serve investors and to preserve the integrity of the financial market, it is of utmost importance that sufficient attention is given to the continuation of systemically important market functions.

This has to be achieved through a combination of sound and rigorous regulations at the domestic level, and cross-border information sharing and regulatory co-operation at the international level. The SFC therefore is a stern supporter of international regulatory organisations that bring together different regulators with different techniques and expertise, who will provide for a diversity of perspectives and information to facilitate the early detection of risks or matters that could pose threat to the stability of the financial system.

As an international asset management centre, it is important that the SFC participate actively at the international level as these changes are developed and introduced, for various reasons. First, we have to keep abreast of international developments so that our standards are maintained at internationally-recognised level. Second, our representation at



international organisations allows our concerns to be heard and understood, and this is crucial to influencing the regulatory outcome. Third, we are truly a global money centre and we therefore have to nurture and maintain cooperative relationships with overseas regulators so that we understand their regulatory philosophy and practices and know how best to protect investors when issues arise across borders.

SFC's work at the international level

Hong Kong is involved in various committees of the Financial Stability Board (FSB). In particular, the SFC represents Hong Kong as a member of the Standing Committee of Standards Implementation of the FSB and participates in its subgroups such as the FSB Implementation Monitoring Network and the FSB Expert Group. In addition, I chair the FSB Italy Peer Review Team to follow up on the Financial Sector Assessment Programme conducted in 2006. The FSB country review of Italy is scheduled to be completed in early 2011.

The SFC is an active participant of the IOSCO, and regularly evaluates the applicability of guidance issued by IOSCO and its implementation by SFC-licensed entities. The SFC actively participates in the numerous IOSCO task forces, standing committees and work groups, engaging in various regulatory initiatives.

To name a few, the SFC is an active participant in the IOSCO Standing Committee 1 which is involved in the International Accounting Standard; the SFC was involved in the devising of the template published by IOSCO for global collection of hedge fund information; and I chair the task force established to work on the new short-selling related regulatory reforms.

On the front of over-the-counter (OTC) derivatives, the SFC is a member of the Sub-Group 2 on Risk Management in the joint working party between Committee on Payment and Settlement Systems (CPSS) and IOSCO to review the CPSS/IOSCO requirements for central counterparties. The SFC has joined the Steering Committee of another CPSS-IOSCO Working Group to establish principles for financial market infrastructures which are also relevant to central clearing parties offering clearing services for OTC derivatives. The SFC is also a member of the OTC Derivatives Regulators' Forum which was established to provide regulators with a means to cooperate, exchange views and share information related to OTC derivatives.

Hong Kong's adoption of international practices

Hedge Fund

The SFC had engaged in several initiatives in the past few years in response to the growth and the changing landscape of the hedge fund industry in Hong Kong. For example, Hong Kong is the first jurisdiction to introduce guidelines to regulate hedge funds offered to the public. While some jurisdictions are now putting in place a licensing and supervision regime covering hedge fund managers, we already have regulatory supervision over those hedge fund managers who operate in Hong Kong. There is no minimum size exemption from the licensing requirement. Licensed hedge fund managers are subject to the Management, Supervision and Internal Control Guidelines issued by the SFC, as all other licensees are. These Guidelines include guidance and suggested controls on risk management.



However, in response to the growth and the changing landscape of the hedge fund industry in Hong Kong, we streamlined and clarified the licensing procedures for fund managers in 2007. This has resulted in the simplification of the licensing process for firms which are already licensed or registered as investment managers or advisors in other jurisdictions and which have a good compliance record and serve only professional investors.

Lately, the SFC has completed its third fact-finding survey on the Hong Kong hedge fund industry in conjunction with the data collection exercise coordinated by IOSCO to collect information concerning global hedge fund activities. According to the results of this latest survey, assets under management or advisory (AUM) in Hong Kong increased 14% from the time of the last survey in March 2009 to US\$63.2 billion as at 30 September 2010.

The number of hedge funds managed by the SFC-licensed hedge fund managers in Hong Kong stood at 538 as at 30 September 2010, similar to that in 2009 and nearly five times the level in 2004, the earliest year covered in similar SFC surveys. The hedge funds invested mainly in Asia Pacific using equities long/short strategy and multi-strategy. As at 30 September 2010, 66.1% of the total AUM was invested in the Asia Pacific markets. Overseas investors continued to dominate, with 92.1% of the investors being from overseas.

On the international front, in addition to our active participation in the IOSCO's discussions in setting internal standards and good practice for the hedge fund industry, the SFC has also performed joint inspections with the Securities and Exchange Commission of the United States on some dual-registered hedge fund managers.

Sound Compensation Practice

The FSB has done much work aimed at implementing standards on compensation that is aligned to prudent risk taking, supported by governance arrangements. The SFC supports the initiatives of the FSB and issued letters in March 2010, to call on major investment banks that are part of an internationally active financial conglomerate to review their remuneration practices by reference to the FSB recommendations. We also requested that they ensure their incentive structures are consistent with prudent risk management. In particular, the SFC highlighted the FSB recommendations regarding effective governance of remuneration and the alignment of employees' incentives with the long-term profitability of a firm. In addition, remuneration should be adjusted for all types of risk and be sensitive to the time horizon of risks.

Short selling

The global financial crisis has highlighted the potentially destabilising impact of short selling, its potential for misuse and its adverse impact on market confidence. In response, many major economies have adopted significant changes to rules regarding short selling within weeks after the onset of financial turmoil in September 2008. IOSCO has also reviewed the practice of short selling and endorsed four principles for a fair, orderly and efficient market. These deal with operational controls, market disclosure and reporting of short positions, compliance arrangements and exemptions from regulatory requirements. As mentioned just now, I chair the task force set up by IOSCO to work on the new short-selling related regulatory reforms.



Unlike most jurisdictions, the SFC did not have to introduce any temporary measures to restrict short selling at the time of the financial turmoil in 2008. Instead, Hong Kong held onto its established framework for regulating short selling, which has proven to be robust throughout the financial crisis.

Having said that, we have remained proactive in our regulation. The SFC issued the Consultation Conclusions on increasing Short Position Transparency in March 2010, with an aim to introduce a short-position reporting regime to enhance transparency of short-selling activities in Hong Kong. The proposed short-position reporting regime is risk-based and will only be applicable to constituent stocks of the Hang Seng Index, the H-share Index, financial stocks and other stocks specified by the SFC. Derivatives will not be included. The SFC will publish aggregated short positions of each stock on an anonymous basis. The new reporting model will be implemented by a new subsidiary legislation, on which the SFC will be consulting the public in due course.

Credit rating agencies

Another area that the global financial turmoil has revealed as requiring regulatory attention is the use and quality of credit ratings. The IOSCO has responded with updating its Code of Conduct to provide more detail on minimum standards for regulating the activity of credit rating agencies (“CRAs”). The SFC has also taken steps to establish a regulatory regime for CRAs. In July 2010, the SFC published a Consultation Paper Concerning the Regulatory Oversight of Credit Agencies and has garnered overwhelming support from stakeholders. This initiative is an important move for Hong Kong and is necessary in order to ensure that regulation in Hong Kong in this area keeps pace with international initiatives.

As a result, there will be the creation of a new type of regulated activity under the Securities and Futures Ordinance (SFO), namely Type 10 Regulated Activity: “providing credit rating services.” To help implement these proposals, the SFC will work with the Government to introduce necessary amendments to the SFO. The legislative amendment process is expected to be completed in the early part of 2011, with a view towards commencing immediately afterwards the licensing process for the CRAs operating in Hong Kong and for their rating analysts.

As the regulation of CRAs internationally is still evolving, the SFC will closely monitor overseas developments with a view to the local regulatory regime being brought appropriately in line with those that are taking shape in other major jurisdictions.

OTC derivatives markets

Supported by financial innovation, these OTC products have grown exponentially in recent years and could pose substantial systemic risk to the financial market if not properly supervised. The FSB has ranked high on its agenda initiatives to strengthen the robustness of the OTC derivatives markets, including strengthening capital requirements to reflect risk in OTC markets and incentivising the use of central counterparties. At the same time, IOSCO has agreed high-level principles which are intended to support the development of appropriately regulated structures to clear standardised credit default swaps. Assessment and implementation of these principles is still at an early stage.



In December 2011, the Hong Kong Monetary Authority (HKMA) and the Exchange respectively established a trade repository and a central counterparty for OTC derivatives transactions in Hong Kong. These key financial market infrastructures aim to enhancing the transparency of and reducing overall counterparty risk in the OTC derivative markets. The SFC will continue to work with the Government and other relevant stakeholders to build a regulatory regime for OTC derivatives markets covering in particular the reporting and clearing of OTC derivatives transactions. At the initial stage, the reporting and clearing requirement will be applied to interest rate swaps and non-deliverable forwards. The SFC plans to consult the market on the regulatory regime by the third quarter of 2011.

Sponsor regime

Finally, I would like to share with you some observations we have made in a theme inspection of IPO sponsors, a findings report of which will be released today.

The current sponsor regime has been in place since the Sponsor Guidelines came into effect in 2007. As with other aspects of our regulation, it is important that we gauge the effectiveness of the regime once it has been running for a meaningful period. As a major IPO centre in the world – we became the largest IPO centre in 2009, having raised a total of \$248 billion - Hong Kong needs a robust sponsor regime if we are to maintain the high standards of listings international investors expect of us.

Sponsors play a pivotal role in the listing process, from its close involvement in the preparation of the applicants' listing documents, to conducting due diligence on the applicants and ensuring compliance with specific requirements in the Listing Rules.

The SFC is concerned that during the theme inspection certain deficiencies have been identified in the due diligence work of some sponsors, in some cases in the listing application process, and in others in the internal systems and controls over sponsor work. Obviously, for sponsors to perform their roles properly, they must acquire a reasonable understanding of the listing applicants' businesses. Equally important is for sponsors to have sufficient expertise and to be adequately resourced.

We have already asked the relevant sponsors to take appropriate actions to address our concerns, and to pre-empt any such lapses in the future. We will also follow up with the Exchange to address the disclosure concerns. Given bank sponsors play a dominant role in the sponsor industry, we have shared our findings with the HKMA. We will continue to engage the HKMA in the supervision of sponsors.

Going forward, the SFC will review existing requirements relating to the work of sponsors. This will be part and parcel of our continued efforts to enhance investor protection and improve market quality. Towards this end, we will work closely with the Exchange as the frontline regulator of listing-related matters, with the HKMA as the frontline regulator of banks, as well as with sponsors and the industry in general.

Concluding remarks

Let me end my presentation by saying that our regulations are not made to prevent innovation, as financial innovation, if properly used by intermediaries and understood by investors will contribute to good market outcomes. Instead, our regulations are aimed to



achieve an appropriate supervisory framework for intermediaries on the one hand, and transparency and understandability to investors on the other.

The challenge that both the fund industry and investors face is the increasing use by funds of derivatives and sophisticated financial instruments. It is imperative that all stakeholders implement the proper compliance techniques and controls to effectively and efficiently manage the risks involved. At the same time, investors are now demanding more information and greater disclosure than ever before.

Intermediaries have the fiduciary duty to communicate relevant information to investors in a comprehensible manner. It is only through effective disclosure can investors' confidence be maintained, thus enabling the investment management industry to continue to thrive. With this, I look forward to another year of strong growth in the investment management industry in 2011.

Thank you.