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Fund Managers Drawn to Efficient Markets

1 Feb 2007

The SFC would continue to enhance the efficiency of the market, SFC's Chief Executive Officer, Mr Martin Wheatley, said today.

This was critical to the development of the fund management industry in Hong Kong as managers tended to be drawn to efficient markets, he said at a [luncheon of the Hong Kong Investment Funds Association](#).

Mr Wheatley said the SFC had over the past years implemented many measures to reduce transaction costs, create a user-friendly trading environment and facilitate product development. The SFC would continue its work in the current competitive environment, he added.

For instance, the SFC has proposed amendment rules to adjust the position limit for H-shares index futures and options to cope with market growth. The SFC is also considering adjustments for the Hang Seng Index futures and options contracts.

Furthermore, the SFC is working on a mechanism that would allow for the suspension of the uptick rule on short selling. The rule may inhibit timely execution of transactions and affect the price-formation process in the stock market.

As one of the three key messages of his address, Mr Wheatley said: "The SFC is committed to maintaining a robust regulatory platform and an efficient marketplace and will continue to work closely with the industry to reinforce Hong Kong's position as the premier asset management hub in Asia."

He also said that market players should be ready to adapt rapidly to changes and seize the opportunities emerging from the Mainland market.

In addition, he said: "Hong Kong's asset management industry was growing from strength to strength and all parties should all work together to ensure that it stayed healthy and competitive."

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Hong Kong Investment Funds Association Luncheon
The Outlook for the Fund Management Industry in Hong Kong
Martin Wheatley
CEO, the Securities & Futures Commission
1 February 2007

Good afternoon ladies and gentlemen

I would like to thank the HKIFA for inviting me. It is indeed a pleasure to join you today to share with you my thoughts on the development and prospects of the Hong Kong asset management industry.

Hong Kong as a major international financial centre

It is a good morale boost for Hong Kong to be rated the freest economy in the world for the 13th year in a row by the Heritage Foundation and the Wall Street Journal. As a major international financial centre, Hong Kong is well equipped with an extensive array of fundamental strengths, such as a well-established and advanced system of financial services, a rich pool of professional talent, a low and simple tax regime, and, not least, proximity to the Mainland.

We are fortunate to have a Government that is fully committed to providing a conducive environment to attract overseas foreign investment. For instance, the Government has abolished estate duty and introduced profit tax exemption for offshore funds. Such measures substantially enhance our competitiveness in comparison with other international financial centres, including the US and the UK, and other financial centres in the region such as Singapore.

Hong Kong has a robust regulatory framework that protects investors and facilitates the orderly development of the financial system. Regarding investor protection, we act as a gatekeeper to ensure that only fit and proper person with sufficient knowledge in Hong Kong regulatory framework could provide regulated activities. Further, we encourage partnership with the industry to promote innovation and development. All along, the SFC has been working closely with the fund management industry in developing rules and regulations on a wide range of products and in enhancing and expanding the range and quality of services. This is a healthy two-way process and I fully support continuing to work closely with the industry in order to maintain the competitiveness of our fund industry.

I want to make it clear that we will continue to require a person who provides regulated activity to go through our licence application process, as we believe that this is the right thing to do. But we will certainly continue to review the process and provide guidance on licence application. You may recall that recently we published an article pointing out certain common deficiencies in the licence applications previously submitted to us. I hope that this will help new comers to prepare their submissions in better quality so that our processing time could be shortened.

Growth of Hong Kong's asset management industry

I have noticed every speech in Hong Kong has lots of numbers. Let us move on to some numbers so that you will have a better idea about how the industry is doing. Without doubt, our fund management industry has registered another year of record growth. In 2005, Hong Kong's combined asset management business, which included asset management, advisory business, other private banking business, and REITs management, amounted to US\$580 billion which was a 25% increase over 2004. In the same period, the size of Hong Kong's combined fund management business as at the end of 2005 was equivalent to 55%¹ of Hong Kong's stock market capitalization.

Hong Kong continues to be a leading financial centre with a strong international flavour. Most of fund management business comes from overseas. Capitalizing on Hong Kong's position as a magnet for overseas funds, companies continue to select Hong Kong as one of their key strategic markets to conduct asset management business.

Growth of Hong Kong's hedge funds market

Hong Kong is not only a leading asset management centre for traditional funds but also for hedge funds. AsiaHedge reported that Hong Kong has got the largest number of new Asian hedge funds within Asia in 2005 and 2006. In respect of aggregate asset size of these start-ups, Hong Kong also ranked first within Asia in both 2005 and 2006 followed by Japan, Australia and Singapore.

To keep abreast of the hedge fund market in Hong Kong, we conducted a survey on hedge funds managed by our licensed fund managers in 2006. The findings of the survey showed significant growth in the number of hedge fund managers, hedge funds and aggregate assets under management during the period from March 2004 to March 2006. The total hedge fund assets under management in Hong Kong also increased by a staggering 268% to US\$33.5 billion over the same period, and the number of hedge fund managers doubled to 118 as of March 2006. Now, we have about 140 licensed hedge fund managers / advisors in Hong Kong.

Turning to the retail hedge funds market, Hong Kong is one of the very first jurisdictions in the world to allow the sale of hedge funds to the retail public since May 2002. There are now 14 retail hedge funds authorized by the SFC with a total net asset value of over US\$1.66 billion² at the end of 2006. Although the size of authorized hedge funds is relatively small in the context of the whole hedge fund universe, the introduction of retail hedge funds does provide investors with an access to a wider range of investment choices.

Development of the retail fund industry

The latest Retail Investor Survey revealed that investment funds were Hong Kong retail investors' second most popular investment, with a participation rate that has

¹ 2004: 54%

² This is more than nine times larger than the net asset value in 2002, the year when the hedge funds guidelines were first issued.

doubled in two years to 18.1% in 2005. Amid the current positive market sentiment and investment environment, we note that the number and size of the authorized unit trusts and mutual funds are increasing and I believe that this growth will continue as investors become more aware of the importance of wealth management and retirement planning.

As of December 2006, the SFC has authorized nearly 2,000 unit trusts and mutual funds for offering to the public. We are also seeing 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 complexity and types of funds available to the retail public. This poses a challenge to regulators and industry participants to ensure that retail investors understand what they are buying into.

UCITS III funds

I would now like to say something about the implementation of the new UCITS III scheme. While UCITS III provides a broader scope of investment possibilities, it is also somewhat of a challenge for Asian regulators. 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 authorization 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. As of December 2006, we have authorized over 93% of all the UCITS III applications received. To further facilitate the application for transition to the UCITS III regime, we have also improved our FAQ on the website to elaborate on the authorisation requirements of UCITS III funds.

Despite the successful migration, we still cannot relax as 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 and a corresponding responsibility on the regulator's part to make sure that such controls are in place and robust enough to do the job.

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 can and do accommodate innovative UCITS III products and we have approved a number of UCITS III funds with special features e.g. guaranteed funds and funds of funds.

ETFs

In the area of ETFs or exchange traded funds, I would say that Hong Kong is doing very well. The launch of a new index fund which tracks the Indian market in November 2006 brings the total number of authorised ETFs in Hong Kong to nine, with an estimated total NAV of over US\$ 9.7 billion as at 24 January 2007. These ETFs cover a diverse range of sectors and include the first ETF in the world to offer non-Mainland investors access to the A-shares market in China and the first bond index-tracking ETF in Asia. It is envisaged that more ETFs will be listed in the coming year to further enrich the product base of the ETF market in Hong Kong.

China opportunities

It is impossible to discuss about the outlook of the asset management industry without mentioning the Mainland, which is becoming a very prominent driver of growth in the region. Many asset management companies have zeroed in on the Mainland as a key strategic market. This is not surprising given that the Mainland possesses the world biggest savings pool³ and the world's biggest foreign currency reserves⁴. Suffice to say that Hong Kong's continued success hinges on how well we position ourselves to successfully tap the Mainland market.

Benefiting from the Mainland's open-door policy as a result of China's WTO accession, many Hong Kong-based fund managers have successfully established joint-ventures with Mainland fund managers or obtained a QFII status to capture the investment opportunities in the Mainland. I have heard that those firms who were not sizeable enough to set up a JV or to obtain QFII status did not give up and found other ways to gain Mainland exposure, for instance, setting up funds with exposure to China A shares via derivatives.

To date, we have 14 retail funds with significant exposure to the China A share market. In June 2006, the SFC authorised the first equity fund that directly invests in A-shares via the fund manager's own QFII quota. With such innovative market players and products, I am confident that our fund management industry will continue to prosper.

There are further opportunities too. In December last year, the Mainland granted more than US\$13 billion quota for Mainland financial institutions that have qualified as QDIIs to invest overseas, including banks and fund management companies. The QDII measures, as you may know, relaxes foreign exchange controls to facilitate overseas investment by qualified banks, fund management companies and insurance institutions. These measures are very welcome and this is an opportunity for Hong

³ US\$2 trillion according to market source

⁴ Over US\$1 trillion

Kong based fund managers to explore the possibility of further expanding their business by developing products or services to suit the needs of Mainland investors.

Efficiency of marketplace

Finally, I would like to talk about the efficiency of our marketplace which is critical to the development of fund management industry in Hong Kong. In general, market efficiency is a vast topic. It ranges from such basics as putting in place an appropriate regulatory and technological infrastructure, to matters such as enhancing market integrity and facilitating market development. Like other investors, fund managers tend to be drawn to markets that are efficient.

There are different ways of enhancing market efficiency, but typically the focus is on implementing measures that will help –

- reduce transaction costs;
- provide an efficient and user-friendly environment within which to trade; and
- facilitate product development.

Over the past years, we have implemented a number of measures along these lines to help enhance market efficiency in Hong Kong. For example, in December 2006, the SFC reduced the transaction levy from 0.005% to 0.004%. In terms of improving implicit costs, the Exchange narrowed the minimum trading spreads for stocks trading between \$2 and \$20 last year. On the product development side, we worked with the Exchange to launch listed callable bull/bear contracts in June 2006. We also introduced listed REITs in Hong Kong starting in November 2005.

To further improve the efficiency of Hong Kong's marketplace in the current competitive environment, we should continue our work. **As you are probably aware, the Government just released the Report on Economic Summit on "China's 11th Five-Year Plan and the Development of Hong Kong".** This report sets out 80 specific recommendations pertaining to Hong Kong's financial services in view of the rapid development of financial markets in China. The recommendations will help broaden and deepen our stock market and thus improve market efficiency.

Let me highlight some of the recommendations that are relevant to our fund management industry.

Position limits

Firstly, position limits are currently imposed on futures and options contracts traded on the Exchange. They restrict the size of open positions that brokers or their clients can take in the futures and options markets. The SFC has been working with the Exchange to review the position limits in order to cope with market growth. We have sent amendment rules to the Legislative Council this week to implement an adjustment to the position limit for H-shares index futures and options contracts. As mentioned in the report, the SFC is also considering adjusting the position limit for the Hang Seng Index futures and options contracts.

Short selling

Secondly, the current uptick rule for short selling may inhibit timely execution of transactions and affect the price-formation process in the stock market. One of the recommendations in the report is to remove the uptick rule. The SFC is now working with the Exchange to consider putting in place a mechanism that would allow for the suspension of the uptick rule.

Conclusion

To conclude, allow me to summarise my three key messages. First, market players should be ready to adapt rapidly to changes and seize the opportunities emerging from the Mainland market. Second, Hong Kong's asset management industry is growing from strength to strength and we should all work together to ensure that it stays healthy and competitive. Last, but not least, as the market regulator, the SFC is committed to maintaining a robust regulatory platform and an efficient marketplace and will continue to work closely with the industry to reinforce Hong Kong's position as the premier asset management hub in Asia.

Thank you.