



Hong Kong as an evolving international financial centre The significance of regulation

HKSI Luncheon

**Mr Ashley Alder
Chief Executive Officer**

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The last time I spoke at an HKSI lunch was about 18 months ago, which was only a week after the launch of Shanghai-



competitive environment, and we need to be agile. So the question is, how does Hong Kong position itself for the future? As an international financial centre like London? As a super-connector for China? As something else? Or as all of these?

We are already a connector as the leading offshore renminbi centre, through the Stock Connect programme and more recently through cross-selling of Mainland and Hong Kong funds in each other's markets under the Mutual Recognition of Funds (MRF) scheme.

But another area where we think Hong Kong should develop significantly is as a centre for managing the more difficult risks arising from overseas institutional investment in the Mainland markets.

Now what do I mean by this? In large part it is about the further development of derivatives, futures and other hedging or risk management instruments which require both sophisticated regulation and world-class, secure pre- and post-trade market infrastructure.

The Mainland authorities clearly remain keen to attract greater onshore participation from overseas institutional investors and, despite concerns about the currency and capital flows, in the longer term to allow Mainland investors to put more of their savings to work outside the Mainland.

To realise this understandable ambition it is essential to have a market with the full range of hedging and arbitrage options, together with the right regulatory and institutional framework to manage the risk profiles of a range of exchange-traded and over-the-counter (OTC) risk management financial instruments.

Since the middle of last year, there have been concerns amongst Mainland authorities about futures and other derivatives. This is largely about the way in which institutional investors were perceived to have had access to onshore derivatives to hedge or speculate on falling prices whilst retail investors were excluded, leading to what were seen to be unfair outcomes. This perception led to new restrictions in the derivatives markets, especially A-share futures. This has meant that investors have fewer choices to manage their long positions effectively.

So as well as Hong Kong's cross border connectivity via Stock Connect and MRF, we believe that Hong Kong should play a major role as a place which originates and clears futures and other derivatives that are more precisely calibrated to manage onshore Mainland risks. This could create a virtuous circle by enabling investors – mainly foreign institutions – to increase their domestic Mainland exposures on the long side. And this, in turn, should increase the volume of risk management activity in Hong Kong – where we are in the right time zone and have the right experience to do this.

Of course, an expansion of our markets to offer more



As all of you will know, GEM was initially conceived at the time of the dot-com bubble with high growth companies in mind, particularly technology companies.

But in 2008 GEM was re-positioned as a stepping stone to the Main Board, with a streamlined process for transfer.

Of course, today's market and business environment is very different to 2008.

Well over 80% of the companies that listed on GEM in 2015 came from traditional sectors such as construction, industry, consumer goods and services.

Now this is a far cry from the original concept of GEM.

And we have also seen that newly-listed GEM companies are often associated with extreme price fluctuations, small public floats and high shareholding concentrations.

In many cases, IPO proceeds are minimal – far too small to justify the expense and effort of an IPO.

It goes without saying that we have been very concerned about these and other developments in our listed market.

So we have been working with the Exchange on an overall review of a range of listing policies, including a holistic review of GEM, backdoor listings, shells and prolonged suspensions.

We think that getting on top of these issues is critical to preserve the quality of Hong Kong's market and that swift and decisive action should be taken to resolve them. You may have seen that David Graham, Head of Listing, Hong Kong Exchanges and Clearing (HKEX), has also spoken recently on these topics – and from my perspective it is good that we and HKEX are working together on this.

Having said that, the risks and regulatory issues relating to the listing market are increasingly complex, and as I have talked about at some length before, much rests on cross-border supervisory and enforcement interaction between the SFC and CSRC, which is going well.

And within Hong Kong we think that there is a compelling case for a far more coordinated approach towards listing regulation. We believe that this requires greater interaction between listing policy and the Listing Rules, which are administered by the Exchange, and the regulation of listed companies and intermediaries by the SFC under the Securities and Futures Ordinance.

The current structure, in which the SFC and the Exchange have separate but overlapping functions and powers, was conceived more than two decades ago.

Today's market carries a far greater variety of complex risks, and this calls for a more coordinated regulatory effort as well as better strategic foresight in policy formulation. The purpose of this is to ensure that Hong Kong remains relevant, competitive and vigilant.

So we think that now is the right time to re-visit the regulatory structure for the listed market, focusing on how the SFC interacts with the Exchange.



As the Financial Secretary mentioned in his Budget Speech this year, the SFC and HKEX are planning to conduct a joint public consultation on this which we aim to release shortly. I am sure this will elicit a wide range of views from a cross section of market participants, and I hope that we can land on a final proposal fairly quickly.

Fund management

Now I would like to turn to Hong Kong and investment funds.

Last year, we built a new strategy for developing Hong Kong as a global asset management centre, with MRF with the Mainland at its core. This was ground breaking because it allowed cross-selling of offshore mutual funds in each other's market for the first time.

Of course, there are several similar initiatives in Asia, including the ASEAN passport scheme, but the potential of the Mainland-Hong Kong market is huge, and the scheme is now the largest in operation. For now it remains the only real channel through which a foreign-branded offshore mutual fund can be sold in the Mainland.

I should give you an update on where we are now. Since the first batch was approved in December, 37 Mainland funds and six Hong Kong funds have been approved. Newly released State Administration of Foreign Exchange (SAFE) data indicates that, by the end of April, Hong Kong funds raised RMB1.36 billion in the Mainland, although Mainland funds have sold less than this in Hong Kong.

Understandably, analysts will focus on early sales data as an indicator of success or failure. Like early H-shares and Stock Connect when first launched, the cross-border traffic under the MRF scheme is not large. But this was to be expected. Markets have been difficult, and we know it takes time to develop distribution capacity and new products. The important thing is that Stock Connect and MRF have operated smoothly and have paved the way for more market integration and connectivity. For Stock Connect, we are looking to extend connectivity to Shenzhen and for MRF we will continue to deepen and broaden the scheme.

As part of our asset management strategy, we are also tackling a number of structural issues.

First, fund structures. This morning the Legislative Council passed the bill that provides for a legal framework to enable the introduction of a new open-ended fund company (OFC) structure in Hong Kong. This will provide an extra option for Hong Kong investment funds to be structured in corporate form rather than as unit trusts. The SFC has already started work on drafting detailed rules for OFCs and we will consult the industry on these.

Second, we are looking hard at fund distribution. Roughly 80% of funds are sold through the bank channel and only 3% by brokers. This concentration implies limited shelf space, high costs and limited choices for investors. To encourage greater diversification, we have been looking at alternative distribution platforms.

First, we have strongly supported the idea of an exchange-sponsored platform to enable



Separately, we want to encourage the growth of in-house or third-party online platforms. Here our conduct rules loom large; we have heard from the industry that many are unclear about account opening and suitability requirements for online and robo advisory platforms.

An SFC working group on suitability, platforms and advice (SPA) was formed earlier this year to clarify our expectations of how the suitability requirement should be implemented across different business models, including exchange and online platforms as well as in the more traditional broker channel. This is a key project on which we will consult the market later this year.

Now as well as these structural issues, another important limb of our asset management strategy concerns new products. The big trend in the global funds industry is obviously the shift to passive management. And here we have seen a rapid growth of exchange-traded funds (ETFs) in Hong Kong, particularly in the last few years alongside the expansion of Renminbi Qualified Foreign Institutional Investor (RQFII) quotas. There are now around 50 ETFs tracking Mainland China indices. About 30 of these track primary market indices and the rest track sector indices. And the top five ETFs account for over 95% of the trading of all ETFs in Hong Kong.

However, we recognise that in this low-yield environment there is a need for more diversification and innovation. For example, the industry approached us about an unconventional product, a crude oil futures ETF, which offers the retail public access to an asset class which previously was confined to institutional money. So in April and May we saw the listing of two ETFs of this type. They were well received with a fair amount of secondary trading.

We will also see the first batch of leveraged and inverse (L&I) products listed on HKEX fairly soon. After the first six months, we will see if the market is ready for the listing of L&I products which actually track Hong Kong indices. However, I should make clear that products tracking Mainland indices are not yet on the table because there is not an offshore market in Mainland index futures which is liquid enough for these products to be viable.

As you may expect, the final but most important limb of our asset management strategy is about regulation. Over the last few months staff from our Investment Products and Intermediaries divisions have consulted the industry about a revamp of the Fund Manager Code of Conduct as well as about a forthcoming liquidity risk management circular.

And here I would just like to spend a little more time on the liquidity issue. Mutual funds are open-ended, with over 95% of them offering daily dealing. The liquidity of the underlying assets, particularly if they are emerging-market bonds, is fair at the best of times, and poor in times of stress. The conventional wisdom that equity markets are liquid is also being challenged. So in this part of the world, we have seen a number of liquidity issues in the A-share market, most recently as a result of the circuit-breaker mechanism, and of course the events of last summer which led to widespread suspensions of A-shares in which funds are invested.

As a fund manager, how do you actually manage the risk of mismatch between redemption pressure and the liquidity of your fund assets? Is your portfolio structured to be resilient to shocks? And have you been monitoring the liquidity profile of your funds on a continuing basis? The forthcoming liquidity risk management circular will aim to provide principles-based guidance in these areas.

