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Putting it right without stifling the industry

A review of the structured products market must be undertaken to understand in detail how our regulatory structure has performed during the recent market meltdown. However, this review must be focussed on improving our system, if necessary, and not become a straight jacket for the financial services industry, said Mr Martin Wheatley, the Chief Executive Officer of the Securities and Futures Commission (SFC).

Speaking at the second annual conference of the Hong Kong Investment Funds Association today, Mr Wheatley said addressing the issues arising from the global meltdown does not mean “throwing the baby out with the bath water”.

“Putting it right does not mean closing down the industry. It does mean finding out what went wrong and making sure that we can design a better system going forward. We should not tar all financial products with the same brush and we need to focus on those structured products which have created confusion and complexity in the market,” he said.

Mr Wheatley stressed that “investment products are ‘sold to’ and not ‘bought by’ investors. It is therefore of paramount importance that selling agents fully understand the investment features and risk profiles of products and take into consideration the investment objectives and unique circumstances of the individual investors when promoting these products.”

Mr Wheatley said that the SFC is now looking into the complaints filed by Lehman Minibond holders to analyse what has happened at the point of sale, where many investors alleged they were sold products which they did not fully understand.

“Both we and the Hong Kong Monetary Authority (HKMA) are working closely to see whether there has been any misconduct or mis-selling of products by licensed institutions and regulated banks,” he added.

In the meantime, the SFC will be working closely with market participants to make sure any changes which may be in place will not stifle what is a healthy and good industry for Hong Kong.

Mr Wheatley's speech is available on the SFC website www.sfc.hk.

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Regulator's Role in Today's Fund Management Business

Martin Wheatley
Chief Executive Officer

29 September 2008

Opening

I'd like to thank the Hong Kong Investment Funds Association for inviting me here to speak today. I didn't know at the time I accepted this opportunity that it would follow such a tumultuous weekend; or that we would be at the heart of the most significant financial crisis that I and any of you have ever seen. And I am sure many of you will have spent the weekend watching nervously for the reports from the US as to whether the so-called Paulson Plan would get approval or not. We've also been watching very nervously to Europe, where Fortis had been going through a weekend of talks and deliberations and ended up being nationalised last night. On top of that, we've got hundreds of people marching in the streets in Hong Kong to complain that they didn't understand the risks of the Lehman's Minibond products which many people in Hong Kong, Singapore and other markets in the region had bought. So this is not a good time.

It's very easy at times like this to write off the financial services industry and we will no doubt see a lot of the commentators doing that. They are writing off the investment banking model as having failed. They are writing off product innovation as having destroyed value. Many people in Hong Kong and elsewhere will have lost some or a significant part of their life savings as a result of what we have seen. Our job is clearly to put that right. Putting it right does not mean closing down the industry. Putting it right does mean finding out what went wrong and making sure that we can design a better system going forward. So, let me talk a little bit today about the fund management industry as we see it, what has happened in that industry over the last year, Hong Kong's position and then I'll come back at the end to what I think are some of the serious issues we're facing today and that we have to address.

Clearly, the fund investment business plays an increasingly important role in the functioning of today's financial markets. It has the objective and usually achieves that objective of allowing investors to channel their wealth into capital markets and achieve long-term savings and growth. But unfortunately, being a participant in today's capital market, the business has been victimised by the recent credit crisis, growing fears of economic slowdown in major countries around the world and the bailout. It seems no financial institution is secure or you cannot guarantee that any FI is secure in today's environment. But let me put into context the profile of the fund management business particularly here in Hong Kong and what recent events tell us.

Profile of the fund management business

Globalisation of market participants and investors

We have seen tremendous growth in the number of cross-border investment managers as well as cross-border marketing of funds in recent years. Out of the 2,200 retail funds authorised in Hong Kong, 76% are domiciled in European countries such as Luxembourg, Ireland and the UK. In addition, 86% of the fund management groups managing SFC-authorised funds are multinational financial groups based in overseas jurisdictions.

The clientele of the fund management business is also highly international in nature. According to our Fund Management Activities Survey which is conducted on an annual basis, overseas investors have consistently accounted for over 60% of the assets managed by licensed corporations, registered institutions and private banks in Hong Kong. Such percentage made new high in 2007, surging to an unprecedented new high of 68% in 2007.

Hong Kong is undoubtedly an international fund management centre. From a regulatory perspective, we have the duty to maintain a rigorous fund regulatory regime that not only facilitates product innovation, but also protects investors' interests, thus preserving the confidence and trust of investors.

Product innovation aided by technological advancement

We now have a plethora of authorised funds with diverse investment styles and risk profiles, managed by investment firms with different backgrounds and origins. In addition to traditional funds like equity funds, bond funds and money market funds, we have by now also achieved a critical mass in alternative investment vehicles, like hedge funds, exchange traded funds and index funds that offer exposure to emerging economies or even commodities. To a large extent, the strong pipeline of product innovation has been facilitated, and to a certain extent, expedited by the evolution of computing power and telecommunications since 1990s.

New technology has enhanced connectivity and driven the speed and transparency of communication across markets. As opposed to the old days where market information was actively acquired by fund managers, market information and data these days are being pushed to your desktop at light speed. This enables fund managers to analyze a multitude of market information, conduct complicated quantitative simulation, and pursue complex strategies in multiple markets, asset classes and currencies. It has also opened up new venues for executing trades, such as algorithm trading or even use of "dark pools" as an alternative platform to minimize market impact, maintain anonymity and manage execution costs. In a quest to remain competitive and in search for alpha returns, investment managers will continue to develop and apply new technologies to formulate innovative financial ideas.

Today's fund management business therefore raises a number of new challenges to financial regulators around the world. First of all, we are now dealing with a fast evolving business. Secondly, investment products are becoming more complex and potentially more opaque. Thirdly, there are heightened operational risks associated with custody, settlement services, valuation of assets, financial well-being of counterparty and performance measurement, in the face of increasing complexity in underlying investments and investment strategies. Failure on the part of any of these service providers may have serious impact on financial stability or result in systemic ramifications, as we have seen in the last few weeks.

International response to the subprime crisis

Since the emergence of the subprime crisis, the International Organization of Securities Commission (IOSCO) has undertaken various initiatives to examine and review the issues surrounding the subprime crisis. As a member of the IOSCO Technical Committee, I would like to share with you some of the findings and recommendations made by IOSCO in relation to the subprime market turmoil.

Back in November 2007, a task force was established by the IOSCO Technical Committee to study the subprime market turmoil that began to emerge earlier that year. The task force was asked to study the subprime issue, its impact to the financial capital markets, and to make recommendations to better protect the investing public from the spill over effects resulting from activity in the subprime market. In addition to the study of the subprime crisis, the Technical Committee also continued its work on the issue of credit rating agencies and analyzed the role played by credit rating agencies in the structure finance markets and the subprime market turmoil.

The task force's findings on the subprime market were published in May 2008. Having studied the developments of the subprime market and the response of regulators worldwide, the task force recommended the IOSCO to conduct further review with respect to these topics:

- Issuer transparency and due diligence by investment managers when investing into these structured products;
- Firm risk management and prudent supervision; and
- Valuation and accounting issues

In its recent meeting in mid-September, amidst the unfolding of some major market events, the Technical Committee engaged in discussions and coordinated its efforts in promoting the smooth and transparent operation of the global markets. In view of the recent developments in the financial markets, the Technical Committee prioritized its focus on two areas:

- Greater international coordination oversight of credit rating agencies; and
- Market participants' responsibility to retail clients. The Technical Committee members expect investment managers to carry out appropriate due diligence to thoroughly understand the risks associated with products that they intend to invest on behalf of their clients. The Technical Committee has been studying this topic, and expects to publish its findings and recommendations in the next few months.

As an active member of the IOSCO, we will continue to devote our efforts into IOSCO's work and contribute to the development of better regulatory standards in the global markets. Closer at home, we will also the make reference to the IOSCO recommendations in our regulation of the industry.

Due diligence by investment managers

Investors have placed their trust on their investment managers by leaving their money with them, and investment managers have the fiduciary duty to conduct due diligence to understand the investments that they are making on behalf of their clients. This includes conducting thorough analysis on the characteristics of the products and assessing their risk profiles and their impact on the overall investment portfolio. The risks involved should be adequately and properly captured in the risk management systems, which incorporate vigorous stress testing.

Apart from being internally equipped with a comprehensive and updated risk management system to monitor the investment activities and manage the risks of their investments, managers should also devote resources on the external front to avoid misunderstanding of their products by investors. In this regard, managers have to provide clear, proper disclosure of the nature and risk profiles of the products in simple language, to facilitate investors make an informed investment decision.

Apparently, investment products are "sold to" and not "bought by" investors. Therefore it is of paramount importance that selling agents of the products fully understand the investment features and risk profiles of the products. They also have a duty to take into consideration of the investment objectives and unique circumstances of the investors when promoting investment products. At the same time, given the complexity of the products, managers have a duty to clearly communicate and clarify the intricacies of their financial products to their distributors and their sales agents to equip them with the knowledge and expertise to assess the suitability of the products vis-à-vis the specific circumstances of their clients, and to explain the products to them.

SFC's role in the Hong Kong fund market

As a regulator, the SFC does not only face the challenges posed by the global market events, but also the regulatory challenge of keeping pace with new developments and facilitating product innovation, and at the same time, maintaining investor protection and market stability. Clearly, we are now operating in a changing and fast growing environment, which means that to remain effective, we have to be a dynamic regulator.

We are aware that product innovation is imperative to the long-term development of the fund industry, and in more macro terms, the financial market. Having said that, the recent market turmoil stemming from the subprime crisis and the failure of major financial institutions have demonstrated that market innovation has become so complicated and has magnified investment risks to such an extent that it could lead to catastrophic consequences and permanent impact to the financial market.

Given the dynamics of today's fund industry, it is only practicable for us to adopt a principle-based regulatory framework, which can sustain over time and provide flexibility and scalability. However, in order to maximize the effectiveness of this approach, firms must also exercise self-discipline, develop and implement proper controls and risk management that are commensurate with their unique business models and nature of investment activities. Firms also need to remain vigilant to changes to the market landscape and enhance their monitoring and risk controls system accordingly.

While facilitating market development, we will also devote our attention and efforts to discharge our duties to uphold market standards and combat market misconduct while maintaining market stability. In this respect, we have taken various actions over the past year, including:

- Securing the conviction of an individual for insider dealing; the first since insider dealing was made a criminal offence under the Securities and Futures Ordinance (SFO);
- Prosecuting and taking disciplinary action against individuals for conducting “marking the close” activities;
- Obtaining a court injunction to stop an unlicensed firm from carrying on futures dealing business; and
- Investigating suspected boiler room activities.

Amidst this unprecedented global financial crisis, we will dedicate our efforts to ensure that market operations are conducted smoothly and in an orderly fashion. We will also continue to vigorously monitor market activities and take decisive actions against those who commit misconduct in the market.

We also need to continue to work alongside industry players like yourselves who are at the forefront of market development and serve as a useful source of information for policymakers like the SFC. It is important that we listen to your views, monitor trends, and assess the effectiveness of principles and regulation on a continual basis.

Conclusion

Now you will know that the government has asked us to do a three-month review of our structured products market. They have asked us to do this on the back of what has become a significant issue in Hong Kong, where individuals feel they were sold products that they did not understand; that they were sold products that they had thought were alternatives to bank deposits. These products are complex products. In today’s very difficult market, those products have become exposed to risks on the other side of the world that nobody concerned or certainly the individuals thought could happen. The allegations that we are investigating are not only that the individuals did not understand those products but the people selling the products to them did not explain or attempt to explain them.

The structure that we have in Hong Kong is a fairly clear structure. The SFC has a duty to approve the prospectus and to approve the marketing materials - and we do that. Our job is to make sure that those documents properly disclose the risks and financial profile of the products. We do not approve or endorse the products. Unlike CIS funds, our role is not to approve the product but simply to say the documentation properly discloses the risks. Another key part of our regime is that our Code of Conduct requires the selling agent properly understands the client – the Know Your Client responsibility, properly understands the risk profiles of the client, and will assess the suitability of a product for a client. The distributor agreement in every case will require that the selling agent explains the product to the client and receives a written confirmation at the point of sale that the client has read all the documentation, has understood the product and has understood the financial risks that they bear when investing in the product.

Based on the complaints that we’re receiving, that process may not have happened. We are currently in the process of analysing what has happened at that point of sale. Both we and the Hong Kong Monetary Authority are looking closely at whether there has been misconduct and mis-selling in our licensed institutions and regulated banks.

At the same time, we have been asking all of you, and we've realised that we've put quite a burden on you and so thank you for providing us the information, for more information about the sorts of products that you manage, the exposure of those products, the underlying characteristics of those products and how those products might operate in very difficult market conditions. Whilst we are analysing that, we need to make sure that we have understood those products which may impose more risks to individuals in a global meltdown and those risks which impose less. It is not our job to tar all financial products with the brush of certain toxic waste – certain structured products have created confusion and complexity in the market. So, we will work very closely with you and we need your input to make sure that we do not throw the baby out with the bath water, and stifle what is a healthy and good industry for Hong Kong.

Thank you all very much.