

ASIA-PACIFIC REGULATORS' AND INDUSTRY DIALOGUE

Session 7

Plugging the Gaps

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SUMMARY PAPER

Introduction

Ageing population

1. As at the end of 2007, persons aged over 65 accounts for 13% (880,000) of Hong Kong's total population (6.96 million). The proportion of the population over 65 is expected to rise from the current 13% to 27% by 2033.
2. Hong Kong's dependency ratio (number of persons over 65 per 100 persons aged 15 – 64) will also rise from 16.3 in 2004 to 42.7 in 2033.

The Mandatory Provident Fund (MPF) scheme

3. Introduced in 2000, the MPF Scheme is a defined-contribution scheme requiring employers and full-time employees to contribute at least 5% of their salary each month subject to a cap. Benefits are paid out as a lump sum benefit at retirement (aged 65).
4. With the introduction of the MPF scheme, 85% of Hong Kong's workforce is now covered by either MPF or ORSO schemes, statutory pensions or provident funds, compared to only one-third prior to the introduction of the MPF.

Need for post-retirement financial planning

5. With MPF program still in its relevant infancy, there is demand for additional retirement planning for those retiring in the next 5 to 10 years.
6. The high living cost in Hong Kong and the burden of medical care for a retiree also contribute to the demand for private pensions and the expansion of the wealth management business in Hong Kong.

Growth opportunities for wealth management and private pensions

7. Hong Kong has one of the highest national savings rate in the world. In 2007, Hong Kong's national savings rate equaled 33% of Hong Kong's GDP, higher than all G7 countries.
8. Hong Kong people have an appetite for a wide range of investment products in managing their wealth. According to the SFC Investor Survey conducted in 2005, stocks are the

most popular investment product amongst Hong Kong adults, as 28.3% of the Hong Kong adults said they have invested in stocks.

9. Managed funds (excluding MPF), is the second most popular investment product, with 18.1% of the Hong Kong adults saying that they have invested in managed funds. This is almost double the percentage of retail participation in managed funds 5 years ago.

Hong Kong as an asset management centre

10. Hong Kong is one of the leading asset management centres in the world. According to our Fund Management Activity Survey (FMAS), as at the end of 2006, the total combined assets under management stood at US\$789 billion, a growth of 36% from the previous year.
11. All funds offered to the Hong Kong public must be authorized by the SFC. As at the end of 2007, there were 2,040 SFC-authorized retail funds, with a total net asset value of US\$910 billion.

Risks and Challenges in the asset management world

At the macro level

12. The increase in the demand for pension funds by baby boomers approaching retirement has led to an imbalance of demand and supply of traditional investments. In order to seek the desired returns, pension fund managers have to invest in other alternative investments.
13. On the other hand, risks have become highly globalized via financial innovation and risk transferring. For instance, investment products that were previously offered only to institutional investors are repackaged into products that are capable of being marketed to the general investing public.
14. The emerging markets have been a popular investment sector for asset managers recently given its substantial returns. However, the pursuit of higher returns in the emerging markets also carries additional risks due to the market characteristics of the emerging markets.

At the micro level

15. Local investors face the risk of being recommended on investment products that may not suit their investment objectives. Instead of recommending products that are consistent with the investor's investment objective, investment advisers may promote products that provide the highest commission, as it constitutes their main source of remuneration.
16. With respect to products, investors may face credit risks from issuers of structured products. Liquidity risks may also arise from the structured products if they are thinly traded. When investing in funds, investors may face risks arising out of the lack of proper internal control and risk management of the asset manager.
17. Investors also face potential risks from distributors of investment products. For instance, front-line sales of investment products may not make sufficient disclosure of the

investment risks of a particular product. Given the market practice of remuneration by sales commission, conflict of interest may arise for front-line sales between selling products which generate the highest commission and providing impartial and objective investment advice to the client. Such conflicts may also not be fully disclosed to the investors.

Addressing the market risks

18. In addressing these risks, the SFC adopts a three-prong approach: products, intermediaries, and investor education, with the aim to strike a regulatory balance between regulation and facilitation.

(I) Products

19. Hong Kong operates on a product authorization regime for retail investment products. All funds offered to the Hong Kong public must be authorized by the SFC. There are structural safeguards in respect of the operator of the collective investment schemes, investment restrictions and objectives and disclosure level of fees and charges. Funds are also subject to certain ongoing reporting requirements.

20. Facilitating the development of the market, Hong Kong is one of the first jurisdictions to authorize hedge funds for sale to the public. SFC has specific requirements with respect to the structure of authorized hedge funds, the qualification of the hedge fund managers, as well as the initial and ongoing disclosure of fund information.

(II) Intermediaries

21. Fund managers and investment advisers are required to be licensed by the SFC. To facilitate market development, the SFC has a specialized team to handle licence applications of non-conventional fund managers.

22. Besides licensing, the SFC also supervises and monitors intermediaries through prudential reviews and on-site inspections using a risk-based approach. The SFC also carried out theme inspections in relation to recent market issues, including:

- Anti-money laundering
- Hedge fund managers, including a joint inspection with the US SEC on selected hedge fund managers that were also registered with the US SEC
- Conduct of investment advisers.

23. The two inspections conducted in 2004 and 2006 respectively are mainly focused on investment advisers' selling practices and their compliance with the relevant rules and regulations. The following issues were identified from the inspection:

- Insufficient knowledge of clients
- Lack of proper due diligence on the products sold
- Lack of justification to illustrate suitability of advice
- Ineffective management supervision
- Poor documentation.

24. In light of these findings, the SFC has taken some follow up action to address the issues from these findings, including:

- Issuance of a sales practice checklist for investment advisers
- Take regulatory action against investment advisers
- Issuance of investor education brochures.

(III) Investor education

25. The SFC runs campaigns to promote investors' awareness in making informed investment decisions. For example, the SFC issues brochures providing basics of fund investing and guidance for investors to assess the suitability of the investment advice.
26. The SFC also conducts teacher workshops to promote financial literacy and to encourage the adoption of a responsible and informed attitude towards personal financial management to the younger generation.

Going forward

Market growth

27. There are significant growth opportunities for the Hong Kong wealth management sector as a result of mainland China's economic growth and development of its financial industry. The recent QDII scheme allowing mainland China funds to invest overseas have provided Hong Kong financial services sector with new opportunities.
28. Given Hong Kong's proximity and close relationship with China, it is envisioned that Hong Kong will continue to play an important role in assisting mainland China intermediaries and investors to gain exposure and experience to investment at the international level.

Regulation

29. With regards to the regulation of Hong Kong's securities markets, the SFC, working together with the industry, will continue its three prong regulatory approach to regulate, facilitate, and protect investor's interest.