

## ETFs – Lessons from a Twenty-year Success Story The 4th Indexing & ETF Investments Series Conference 2013 China

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### Introduction

Good morning ladies and gentlemen.

I would like to first thank the organiser for inviting me here to give the opening remarks.

I am very pleased to have the opportunity to speak to you today. As some of you may know, a key part of my job at the Hong Kong Securities and Futures Commission is the regulation of publicly-offered investment products. ETFs are an important part of the investment product universe. In fact, my team and I have been working on the regulation and development of the ETF market since this product category first appeared in Hong Kong in 1999. The development of the ETF industry is something I follow closely.

ETF is a big success story. It has a relatively short history. The first ETF was launched in Toronto just over twenty years ago. Then in 1993, the SPDR S&P 500 ETF was listed. It played an important role in popularising ETFs among the international investment community. The SPDR S&P 500 is now the world's largest ETF, with about USD120 billion under management. It was followed by many other successful ETFs. Today, asset under management by the industry totalled USD2 trillion worldwide. This is comparable to the total amount of money that hedge funds manage.

I would like to share with you my thoughts on what underlies this spectacular growth and what could prevent it from continuing. I would like to offer some advice on how the industry and the regulator could work together to keep up the momentum. At the SFC, I also oversee the Commission's Mainland policy. I believe that the interaction between the Mainland and Hong Kong markets could have some major implications on the ETF industry in the region. I will spend some time elaborating on this.

### Factors of success of ETFs

ETFs embody many characteristics that investors and regulators find desirable. Many ETFs are straightforward. They track the performance of generally well-known indices. ETF prices simply reflect the performance of the underlying indices. In many cases, the pricing of ETFs is also very competitive. Some ETFs can have an expense ratio of less than 0.1%, against more than 1% for some actively managed funds. And it is not just about cost. In terms of return, research has shown that many benchmark indices, and by implication for the ETFs that track them, often outperform actively managed funds that invest in that particular sector.



In addition, ETFs are convenient. They can be bought and sold just like any other listed stocks. The proliferation of ETFs on the back of their success also means that there are now ETFs to meet many different investment strategies. All these factors combine to make ETFs an important building block in the portfolios of many investors.

### **Regulators' concerns over ETFs**

Just like many other financial products, as ETFs became more popular and their population grew, the market became more crowded and started to commoditise. To build an edge for themselves, issuers began to innovate. Many of the innovations, such as improving tracking accuracy and offering products that are more tailored to specific investor needs, should be welcomed.

But there are instances where innovation has taken some ETFs off the original value propositions as a transparent and convenient investment product. Such deviations are not inherently undesirable or risky. Yet it is important that the industry and the regulators keep a close eye on them, so that we do not sleepwalk into a time bomb. I will share with you examples of some recent innovations that could create new risks. And I would like to demonstrate how the industry and the regulators have worked towards balancing risk and innovation. I think they carry some useful lessons for many of you that are at the forefront of ETF product development.

#### *Opacity and mis-selling*

The first such risk is opacity and mis-selling. Many investors see ETFs as passive, almost boring products. ETFs replicate indices. Subject to tracking errors and expenses, the price of an ETF and the underlying index should move in lockstep.

In the past few years, we have seen ETFs that are very different from this simple formula. Some ETFs, known as inverse ETFs, seek to deliver the opposite of the performance of the index that they track. Investors make a gain when the indices go down, vice versa. Effectively, an inverse ETF offers a way for investors to short an index.

Take another breed of ETFs known as leveraged ETFs. They seek to deliver multiples of the performance of the underlying index. For a leveraged ETF seeking to deliver twice an index's daily return, for example, each percentage rise in the index should in theory result in a two percentages increase in the price of the ETF unit on that day.

These do not sound terribly complicated. But inverse and leveraged ETFs are re-balanced periodically, mostly daily. As a result, investors that hold an inverse or leveraged ETF in a volatile market would find their return diverging significantly from the trajectory of the underlying index. It is difficult to explain this without the use of numbers and spreadsheets. But this is exactly the point. Questions arise as to whether investors can indeed fully understand the products. The risk of mis-selling and investors buying into something they do not fully understand is compounded by investors' easy access to these ETFs, due to their listed status.

Inverse and leveraged ETFs are more common in the United States. Back in 2009, the US securities industry supervisors, the Securities and Exchange Commission and the Financial Industry Regulatory Authority (FINRA), issued warnings to the industry reminding them of their obligations to provide suitable recommendations to investors and ensure that investors fully understand the products. Yet subsequent events have proved that such warnings were



inadequate. In May last year, FINRA imposed a fine of over USD9 million on four major financial institutions for mis-selling inverse and leveraged ETFs. It remains to be seen whether such sanction would be able to deter future offences, or whether tougher measures are needed.

### *Counterparty risk*

Counterparty risk is another area that has gained prominence. A traditional, “physical” ETF tracks the performance of an index by actually buying its component stocks, often in amounts that reflect the weights of the stocks in the index. There are, however, limitations to this replication method. As the industry expands its coverage beyond major indices, it comes across underlyings that cannot be physically replicated. Such underlyings include commodities, which cannot be bought physically as many issuers lack storage facilities. Such underlyings also include securities in markets with restricted access. Where physical replication is not practicable, issuers typically adopt a synthetic replication strategy. The ETF would enter into a derivative contract with a dealer. The dealer promises to pay a return that reflects the performance of the underlying index in return for a fee.

The use of synthetic replication offer investors access to a broader range of underlyings. Yet it also exposes investors to the credit risk of the derivative counterparties. Particularly during the financial crisis, when the health of many major financial institutions became questionable, synthetic ETFs’ counterparty exposure drew intense scrutiny from investors and regulators.

Synthetic ETFs posted particularly thorny questions to the Hong Kong SFC. About half of all ETFs listed in Hong Kong adopt a synthetic replication strategy. Synthetic replication is particularly popular among ETFs tracking the Mainland stock market. As many of you are no doubt aware, access to the Mainland market is restricted, and synthetic replication is often the only way to gain exposure to this market. Synthetic ETFs tracking the performance of Mainland stocks are an important part of Hong Kong’s product offerings. The first synthetic A-share ETF was launched in Hong Kong in 2004. Within less than 10 years, they are already among the more popular and most actively traded ETFs in our market.

At the SFC, we dealt with the conundrum using a two-prong approach, with a combination of enhanced disclosure and structural safeguards. In 2010, we required all synthetic ETFs to clearly indicate their use of a synthetic replication strategy in their stock short names, which we augmented with a very aggressive bout of investor education. Then in 2011, such an indication must also be included in their product names whenever they appear in offering documents and marketing materials. We also required issuers to enhance the collateral information that they provided. We wanted to raise investors’ awareness of the risk that they are taking.

At the same time, we worked with issuers to reduce the credit risk that derivative counterparties posed. We required issuers to ask for collateral from their counterparties. This is a “best practice” in the derivative world. The full collateralisation requirement was introduced on all Hong Kong-listed synthetic ETFs that were primarily regulated by the SFC in August 2011. We agreed with issuers on a two-month transition period, i.e. by 1 November 2011, the counterparty exposure of all these ETFs must be fully supported by liquid, quality collateral. All of them were able to comply with the requirements before the deadline. Hong Kong’s prompt regulatory response to this risk in fact received commendation in international circles, including in reports issued by IMF on the subject.



## Lessons learnt

I would like to use the above examples to elucidate a few lessons that I believe are important to the continued success of the ETF industry.

First, innovation does have to come at the expense of more complexity and risks. ETFs offer investors a cost effective way to access a particular market. Over the past two decades, the industry has continued to improve and has found more creative ways to do this job better. It strove to drive down costs, improve tracking accuracy, and expand the types of underlying exposure that it offers. For many ETFs, the proposition remains the same, and remains simple. In fact, many of the most popular ETFs today are the forerunners of the industry. They have been around since almost the industry's inception and have been offering the same products. Rather than adding more complicated features, they chose to focus on improving their existing offerings, and many have gained a large following.

Second, if innovation does sometimes result in added complexity and risks, the industry needs to work with the regulators to reach a balanced outcome, always putting investors' interest first. Sometimes the balanced outcome is enhanced disclosure. But disclosure is not always enough. This is a lesson that we learnt, most recently and with agony, from the financial crisis. So there are instances where certain structural requirements are needed. Whatever the appropriate solution is also changes over time. Just as the industry responds to changing market conditions and investor demands, regulators do the same thing. What we do not want to see are situations where investors' interests are undermined and regulators have to take punitive measures. They undermine the public's confidence in the industry, and could potentially hamper investment choices and industry growth.

Finally, I want to stress that innovation is not an anathema to regulators. It is true that by nature, we tend to be more prudent. But many regulators have a keen awareness that starving investors of choice is not the best way to protect their interest. One of the Hong Kong SFC's objectives is to promote the development of the Hong Kong securities market. And I think we live up to that pledge. I recall that back in 1999, when we did not even have an ETF-specific regulatory framework, we worked closely with the Hong Kong Stock Exchange, the Administration, brokers and asset managers to devise an arrangement for the first ETF to list in Hong Kong. The end result, the Tracker Fund, has been a remarkable success. It is now the third largest ETF in Asia outside Japan. Many of the innovations seen in the market are the fruits of the joint efforts of the industry and the regulators. And I hope this collaboration will continue.

## The unique role of ETFs in Mainland-Hong Kong financial cooperation

As interaction between the Mainland and Hong Kong increases and the two markets become more closely integrated, I believe we will see more ETFs that have a cross-border element. ETFs occupy a unique position in Mainland-Hong Kong financial cooperation. Before I close today, I want to spend some time elaborating on this. I think there are a few issues that are worth bearing in mind as you ponder the opportunities that Mainland-Hong Kong financial cooperation could bring.

Investment funds in general, whether listed or unlisted, play an important role in the Mainland's capital market reform and opening up. Investment funds are managed by professionals. Many Mainland policymakers believe that allowing professionals from overseas to participate in the Mainland stock markets help improve overall market efficiency,



particularly when Mainland stock markets are still largely retail-oriented. On the other hand, given that most Mainland investors are not familiar with international markets, giving them the opportunity of investing in the global markets through qualified fund managers may help reduce investment risk. Two of the Mainland's most important financial reform initiatives, qualified domestic institutional investors (QDII) and qualified foreign institutional investors (QFII), were both designed with that in mind.

QDII funds that invest in overseas markets and QFII funds that invest in the Mainland market started as unlisted funds. Partly, this is because of certain technical challenges, particularly as the Mainland still has a capital control regime. Partly, it is because listed funds are generally perceived as allowing a greater degree of trading activities and speculation. That investors can easily access listed fund may also increase the risk of mis-selling, especially when such products are still novelties.

Nonetheless, a number of ETFs tracking Mainland A-share indices sprang up in Hong Kong soon after the inception of the QFII scheme. These ETFs adopted a synthetic replication strategy using derivatives that are issued on the back of QFII quotas. It has been unclear how Mainland authorities see this way of using QFII quotas. But these ETFs have proved to be a major success. The first one of them, tracking the A50 index, has grown exponentially since we authorised it in November 2004. With about USD20 million assets under management at launch, the size has grown to about USD9 billion at the end of January.

The success of these synthetic A-share ETFs shows that ETFs could be an effective channel to connect the Mainland and Hong Kong markets. Since 2009, we have been advocating the launch of reciprocal ETFs in the Mainland that would allow Mainland investors to access the Hong Kong market. As these synthetic A-share ETFs grew in size, post 2008, regulators in the Mainland and Hong Kong also became increasingly concerned about the counterparty risk to which the investors were exposed. We suggested to our Mainland counterparts a separate arrangement that would allow funds in Hong Kong to directly invest in the Mainland markets.

Two major breakthroughs came within the past year or so. At the end of 2011, Mainland authorities announced the RQFII schemes, giving quotas to funds established in Hong Kong to invest RMB in Mainland fixed income and equities markets. Soon after the successful launch of the scheme, Mainland authorities expanded the quotas to allow the launch of physical ETFs in Hong Kong that track Mainland equities indices. The first such RQFII physical ETF was authorised in June 2012, and another three have been authorised since. Investors received these ETFs enthusiastically. At the end of January 2013, the assets under management of these RQFII ETFs totalled RMB47 billion. Among the five most actively traded ETFs listed in Hong Kong, two are RQFII ETFs.

The second breakthrough happened on Mainland exchanges. In October 2012, two Hong Kong-stock ETFs, tracking the Hang Seng China Enterprise Index and the Hang Seng Index, were listed on the Shanghai and the Shenzhen stock exchanges respectively.

Some have remarked that the reception of Mainland-listed Hong Kong-stock ETFs has only been lukewarm. But this is missing the point. The significance of the Hong Kong-stock ETFs in the Mainland and RQFII A-share ETFs in Hong Kong is that Mainland authorities have signed onto the idea that ETFs could play an important role in connecting the Mainland and Hong Kong markets, creating a new channel for two-way capital investment flows. Because of the many advantages of ETFs that I mentioned earlier, I believe that this would add further



momentum to cross-border cooperation between the two markets and would open up major opportunities for the ETF industry in the Mainland and Hong Kong.

Clearly, this is an exciting development, and I encourage you to seize upon the opportunities this creates. You must remember, however, the success did not come easy. RQFII, for example, came after three years hard work by us and our Mainland counterparts. We were able to finally convince Mainland authorities to approve the scheme because Hong Kong has over the years accumulated a wealth of experience in the ETF space, that we have a robust regulatory regime, and that our industry has a stellar track record, not least in having weathered the financial crisis largely unscathed. Any misstep, however, could set us back in years. As you consider the next products that you wish to bring to the market, I hope you will pay special attention to the risks involved and how you plan to manage them.

### **Conclusion**

The global ETF industry has enjoyed an excellent run since its birth just over twenty years ago. The industry offers a transparent, easy-to-understand product that gives investors access to a wide range of underlying exposure in a cost effective manner. Over the years, the industry has been innovating and improving tirelessly. Such innovations and improvements enhance the value proposition of the industry. There are a few instances where innovation has raised alarm. In most cases, the industry has been able to work with the regulators to address them. With some recent breakthroughs in Mainland-Hong Kong ETF cooperation, many more opportunities will arise. I urge you carry on the good work and bring the industry's success to the next level.

With that, I would like to wrap up. I wish you all an enjoyable and useful conference today.

Thank you.