FSDC Paper No. 16

Strengthening Hong Kong as a Capital Formation Centre for Exchange Traded Funds

October 2015

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Executive Summary

Exchange Traded Funds ("ETF") have a relatively short history but have rapidly become a popular investment tool for investors worldwide offering a convenient and transparent means of low cost investment in a particular asset class such as stocks, bonds or commodities. As a regional financial centre, Hong Kong is well positioned to support a thriving ETF market with its sophisticated financial infrastructure and talent. The cross-border cooperation between Mainland China and Hong Kong also opens up major opportunities for the ETF industry in Mainland China and Hong Kong e.g. the Renminbi Qualified Foreign Institutional Investors ("RQFII") ETF products allowing investment directly into the equity and bond markets in Mainland China have become very popular in Hong Kong.

ETFs hold over US$2.9 trillion of assets globally as of May 2015. In the US market ETF assets grew to approximately US$1.9 trillion across 1,600 funds by the end of June 2014; in Europe there are 2,200 ETFs currently on offer as of May 2015. Whilst the asset flows in the developed markets of the US and Europe will continue to dominate the global ETF landscape, Asia (currently accounting for 8% of global assets as of May 2015) is expected to experience significant growth in the coming years due to the sheer number of investors in the region combined with economic growth, rapid wealth creation and a quickly evolving financial services landscape[1].

Hong Kong was the first market in Asia (ex. Japan) to list ETFs with the launch of the Tracker Fund based on the Hang Seng Index in 1999 and enjoyed the leading position in the region by turnover for some years. More recently, however, Hong Kong has fallen behind Tokyo and Shanghai and takes third place in the regional rankings by total turnover. Korea, Japan and most recently Taiwan have gained more traction through product innovation (e.g. through leveraged and inverse ETFs); policy makers of Hong Kong must take actions to enhance the competitiveness of Hong Kong's ETF platform as otherwise its ranking may fall further behind. For example other Asian markets will also compete with Hong Kong in the Asian retirement savings market which has observed significant growth in recent years. Hong Kong also faces other challenges such as the lack of effective ETFs distribution channels. This can be overcome by introducing more innovative and non-traditional distribution platforms to promote ETF products. In addition, efforts can be made in the following areas to enhance further growth in Hong Kong ETF market:

1. Improve investor education in ETF;

[1] ETF 2020 Preparing for a new horizon, PwC, January 2015

2. Promote the usage for ETFs in the Mandatory Provident Fund ("MPF") platform;
3. ETF Mutual Recognition and Shanghai-Hong Kong Stock Connect Scheme;
4. Enhance communication between the industry and the Securities and Futures Commission ("SFC");
5. Improve ETF distribution channels;
6. Nurture local expertise and talent to develop Hong Kong into an ETF manufacturing hub;
7. Broaden the product range - ETF cross-listing;
8. Consider the use of depository receipt schemes and grantor trusts;
9. Develop innovative benchmark indices;
10. Enhance classification of ETFs; and
11. Expand the Double Taxation Agreement ("DTA") network to other territories.

In many ETF regimes, regulatory changes, policy incentives and product innovation have proven to be effective tools to help support the ETF market. Based on PwC Global ETF Survey[2] 56% of the survey participants believed that the regulatory environment made a meaningful impact on the growth and innovation of ETFs to date. When Hong Kong enhances its regulations and policy incentives to promote ETFs, protection of investors must be enhanced in a proportionate manner. This can be achieved by launching public investor education programmes over various channels to improve investors' financial literacy. Whilst investors learn about the potential risks, wider acceptances can also be gained through awareness of the benefits of ETFs and how they could be used by investors. The optimal balance between product innovation and investor protection will be a key element in securing Hong Kong's role as an international asset management centre and global capital formation centre for ETF listings.

In addition, it will be important to have a transparent and predictable platform for issuers to launch ETFs in Hong Kong. Streamlining the ETF authorization process will attract both practitioners and investors to the Hong Kong market, expanding the ETF ecosystem.

The Financial Services and the Treasury Bureau published the *Open-ended Fund Companies Consultation Paper* in March 2014[3]. The ETF industry may work closely with regulators and policy makers to start preliminary study of adopting alternative legal structures for ETFs as well.

As the world's largest offshore Renminbi business hub, Hong Kong is well positioned to facilitate more Renminbi-denominated ETFs to list in the city. As at the end of June 2015[4], RMB deposits in Hong Kong totalled RMB992.9 billion. With the biggest pool of Renminbi outside China, Hong Kong is also the largest centre for conducting offshore Renminbi financing activities,

[2] PwC Global ETF Survey, September 2014
[3] http://www.gov.hk/en/theme/bf/consultation/pdf/ofc_e.pdf
[4] http://www.hkma.gov.hk/eng/key-information/press-releases/2015/20150731-6.shtml

including bonds, loans and equity products. Hong Kong should leverage its success in the offshore Renminbi front and solidify its edge as a leading international financial centre.

The Hong Kong financial services sector currently employs over 230,000 people and is characterized by a high level of knowledge and skills, with 67% of workers with post-secondary education, compared to 35% for the overall economy[5]. Hiring talented professionals in developing innovative products and distributing ETFs effectively in Hong Kong will have a positive effect on employment and reinforce Hong Kong as a knowledge based economy.

[5] FSDC Paper No.13 Developing Hong Kong's Human Capital in Financial Services, January 2015

Section 1 Introduction

1.1 What is an ETF?

Definition

ETFs are passively managed open-ended listed funds. All listed ETFs on the Stock Exchange of Hong Kong Limited ("SEHK") securities market are authorised by the SFC as collective investment schemes.

ETFs are designed to track the performance of their underlying indices or benchmarks, e.g. a commodity price, and offer investors an efficient way to obtain cost-effective exposure to a wide range of underlying market themes. Similar to other listed securities, investors can buy or sell ETFs through their brokers anytime during the securities market's trading hours. Exhibit 1 shows the typical structure of an ETF listed in Hong Kong.

ETFs can be broadly grouped into two types:

1. Physical ETFs

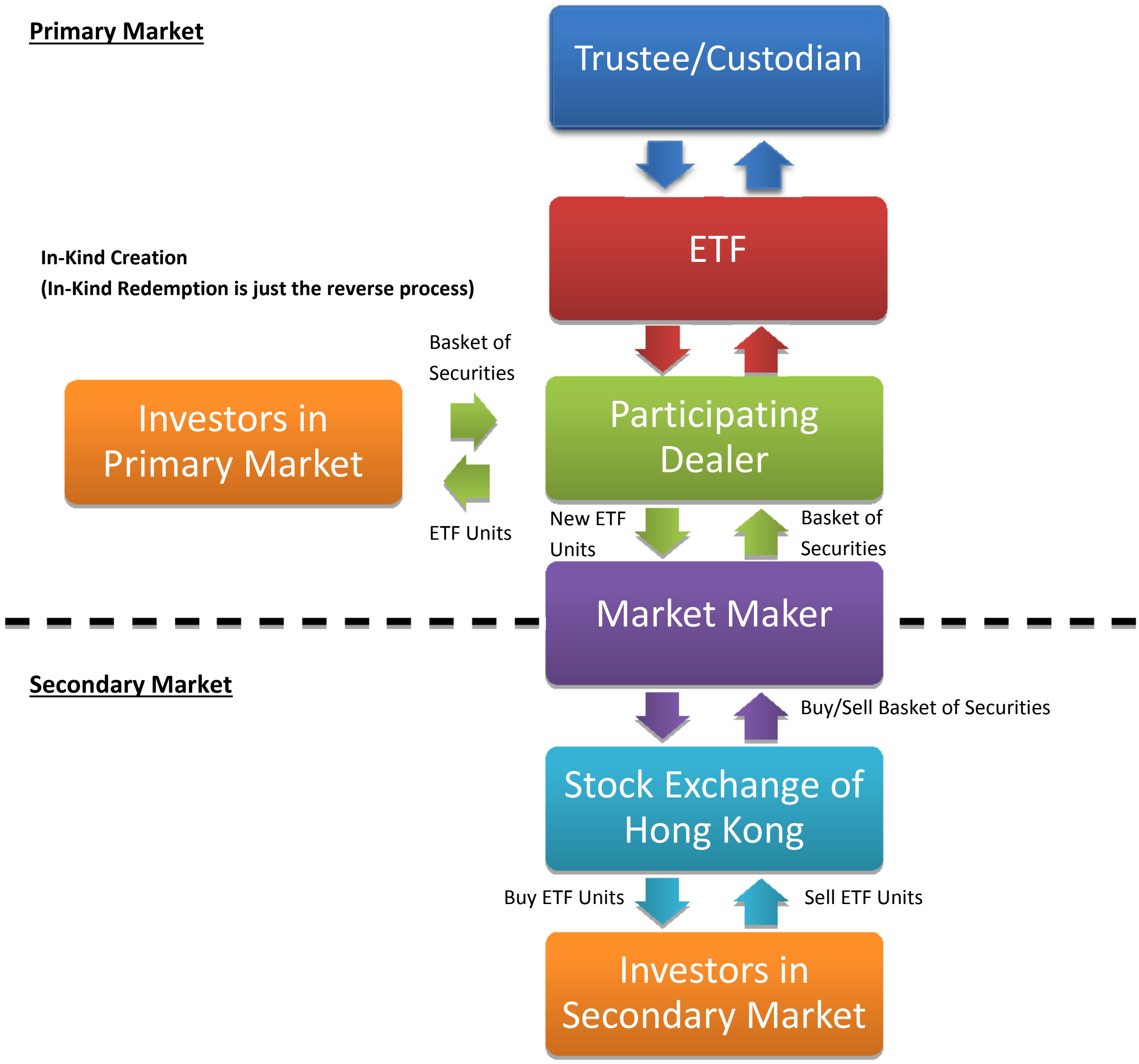
Many of these ETFs directly buy and hold all the assets needed to replicate the composition and weighting of their benchmark (e.g. constituents of a stock index). However, some ETFs use representative sampling to replicate the performance of the underlying indices by buying a portion of the assets needed to replicate the benchmark or assets which have a high degree of correlation with the underlying benchmark.

Some physical ETFs with underlying equity-based indices may also invest partially in futures and options contracts. Lending the shares they own is another strategy used by some physical ETFs.

2. Synthetic ETFs

Synthetic ETFs do not buy the assets in their indices or benchmarks. Instead, they typically enter or acquire financial derivative instruments such as swaps or notes to replicate the relevant index's or benchmark's performance. Synthetic ETFs are required to hold collateral to limit counterparty risk of the derivatives (details of the net and gross counterparty exposure and types and composition of the collateral are published on the ETF's website). Synthethic ETFs should have a collateral level of at least 100% of the ETFs' gross total counterparty risk exposure.

Exhibit 1: Typical ETF Structure in Hong Kong



ETF Manager

The ETF Manager is responsible for placing purchase and sale orders and providing continuous supervision of the investment portfolio of the ETF. The ETF Manager may purchase and sell investments for the account of the ETF and subject to the provisions of its constitutive documents and enter into such contracts including sale and purchase agreements, loans, stock lending arrangements and broker and trading agreements as it deems appropriate in the performance of its role as the ETF Manager. A Hong Kong based

ETF Manager is required to be licensed by the SFC to conduct regulated activity Type 9 - asset management under the Securities and Futures Ordinance.

Trustee/Custodian

The Trustee/Custodian is responsible for the safekeeping of the assets of the ETF, day-to-day administration of the ETF and its portfolio. The Trustee/Custodian may, however, appoint any person or persons (including a connected person) to be custodian of the assets of the ETF or to otherwise act as its agent. The Trustee/Custodian is required to exercise reasonable skill, care and diligence in the selection, appointment and monitoring of such persons and, during the term of their appointment, must satisfy itself as to the ongoing suitability of such persons to provide custodial services to the ETF, having regard to the market or markets for which such persons are appointed to act as custodian.

Participating Dealer

Participating Dealers ("PDs") are institutions authorized to create and redeem interests (shares or units) in ETFs. PDs are Type 1 – dealing in securities licensees and either are participants in Central Clearing and Automated Settlement System ("CCASS") or appoint agents who are participants in CCASS. PDs are usually the only persons who may apply to the ETF to create and redeem shares or units. In essence, the PDs create ETF units or shares through a direct subscription from the ETF in the primary market. PDs can usually create units or shares by giving the ETF Manager a "basket" of securities (called an in-kind transfer), cash that equals the value of the units or shares or a combination of the two. A PD may act for its own account or for the account of its clients in making cash or in-kind creation and redemption applications.

Market Maker

A market maker is a broker or dealer permitted to make a market for the ETF units or shares in the secondary market of the SEHK and whose obligations include quoting bid prices to potential sellers and offer prices to potential buyers when there is a wide spread between the prevailing bid prices and offer prices for the ETF units on SEHK. Market makers facilitate the efficient trading of ETF units or shares by providing liquidity in the secondary market when it is required, in accordance with the market making requirements of SEHK.

The Stock Exchange of Hong Kong Limited

SEHK facilitates the exchange of ETFs between buyers and sellers, thus providing a marketplace for trading ETFs. Most retail investors trade ETFs in the secondary market through SEHK. SEHK provides real-time trading information on the listed ETFs, facilitating price discovery. It maintains the infrastructure and electronic trading systems for trading and clearing of ETFs and regulates market makers of ETFs.

Central Clearing and Automated Settlement System

CCASS is Hong Kong's clearing and settlement system which provides book-entry settlement in securities among its participants, either free of, or against, payment. Only units or shares of ETFs listed or to be listed on the SEHK will be accepted as eligible securities for settlement in CCASS.

Hong Kong Conversion Agency Services Limited ("HKCAS"), a wholly owned subsidiary of Hong Kong Securities Clearing Company Limited ("HKSCC"), can act as a service agent to facilitate the book-entry deposit/withdrawal of the ETF units or shares into/from CCASS for ETFs tracking indices which do not comprise SEHK-listed constituents. HKCAS acts as a conversion agent in the same way for ETFs track indices comprising mostly SEHK-listed constituents.

1.2 Investor benefits

Benchmark tracking

An ETF is a passively managed fund which aims to track closely the performance of the ETF's underlying benchmark. Tracking difference measures the total return difference between the net asset value ("NAV") of an ETF and its benchmark index over a given period of time. Tracking error is a measurement of risk that defines how consistent this return difference between the ETF and its benchmark index has been over time. Where they are different is that tracking difference reflects the amount of outperformance or underperformance against the benchmark index, while tracking error is an absolute figure of variation and does not show the direction of the tracking difference, only the extent of its volatility.

ETFs try to reflect the performance of an underlying assets as closely as possible, but there are times when a fund may trade at a premium or discount to its underlying holdings. When an ETF's price deviates from its net asset value of the underlying holdings, a premium or discount may arise.

When the ETF's trading price is lower than its net asset value, the ETF is said to be at a "discount" – the ETF is trading at less than the value of the ETF's overall holdings. If the ETF's trading price is above the net asset value, the ETF is said to trade at a "premium" – the ETF is trading higher than what the underlying holdings are worth.

Arbitrage activity not only seeks to efficiently match the outstanding supply of shares with demand, but also eliminates trading at large premiums or discounts to the net asset value. This helps support closer tracking between the exchange-listed ETF shares and the ETF's net asset value.

While the tracking error measures how consistent an ETF portfolio follows the index to which it is benchmarked, the price of the ETF traded on the secondary market may deviate from the net asset value of the ETF as measured by its premium or discount.

Transparency

Each ETF has its own website operated by the ETF Manager. The ETF websites provide key information such as the underlying benchmarks and the benchmarks' constituents, each ETF's net asset value, the counterparty exposure and details of collateral from counterparties. The net asset value of an ETF is the sum of marked-to-market values of the individual portfolio holdings plus the portion of the assets held in cash and cash equivalents, less all the accrued ETF expenses. The net asset values of ETFs are calculated intra-day during the trading hours and at the end of the trading day. The intra-day estimated net asset values, or iNAVs, are also known as RUPVs (Reference Underlying Portfolio Value) or IOPVs (Indicative Optimised Portfolio Value). The end-of-day net asset value information may also be obtained on the news website of the Hong Kong Exchanges and Clearing Limited ("HKEx"), in addition to the ETF's website. Real-time or near real time price quotes for ETFs are disseminated by information vendors and are available on the HKEx's news website.

Low transaction costs

Unlike most unlisted funds in Hong Kong, ETFs do not charge any subscription fees. The transaction costs for trading ETFs on the SEHK are the same as those for trading other securities, which include brokerage commission, transaction levy, investor compensation levy (currently suspended), trading fee and trading tariff. The management fee of Hong Kong-listed ETFs ranges from 0.05% to 0.99% annually. The ongoing charges, which include management fees and all applicable charges and payments deducted from the assets of the ETF, ranges from 0.13% to 4.59%.

Low minimum investment

ETFs are traded in board lots and the minimum initial investment is usually set at an affordable level.

Liquidity

ETFs can be traded any time during the trading hours of the securities market. Listed ETFs usually have market makers to provide some liquidity. The main role of a market maker, is to offer bid and ask prices and provide enhanced liquidity for ETF units or shares to allow investors to transact at almost any time during the trading hours. Their services are helpful when trading of a less liquid ETF becomes limited due to the absence of active buyers and sellers. Actively traded ETFs can also benefit from the additional liquidity provided by market makers when there are many orders at the bid and ask queues. The SEHK has stipulated the permissible range and spreads for market makers to fulfill their market making obligations for every ETFs listed on the SEHK.

Most retail investors transact in the secondary market. Secondary liquidity is the "on screen" liquidity that investors see from their brokers (i.e., volume and spreads), and it is determined primarily by the volume of ETF units or shares traded. However, one of the key features of ETFs is that the supply of units or shares is flexible — units or shares can be "created" or "redeemed" at the ETF's net asset value to offset changes in demand. Primary liquidity is concerned with how efficient it is to create or redeem units or shares. Liquidity in one market, primary or secondary, is not indicative of liquidity in another market. The determinants of primary market liquidity are different from the determinants of secondary market liquidity. In the secondary market, liquidity is generally a function of the value of ETF units or shares traded; in the primary market, liquidity is more a function of the value of the underlying assets that back the ETF.

Convenience

ETFs are traded through brokers in the same way as other securities and the settlement arrangements are the same.

ETFs enable retail investors to have cost-effective access to diversify their portfolio. ETFs give retail investors single-trade exposure to a particular index, commodity, equity or fixed income segment. Investors can invest in an Index ETF that tracks the market performance of its underlying index. Several ETFs provide access to a wide range of equities segments, by geography, sectors, investment style or themes, including exposure to international and emerging markets. Investors can expand their investing options by considering the sector, credit rating and maturity of their fixed income choices.

For institutional investors, ETFs are no longer simply a way to gain efficient exposure to a particular asset class for cash equitisation purposes. Uses have evolved to include applications such as liquidity management, asset class exposure and portfolio completion.

In the secondary market, investors bargain with each other or with a market maker to trade the existing supply of ETF units or shares. In contrast, investors in the primary market use a participating dealer to change the supply of ETF units or shares available — either to offload a large basket of units or shares ("redeem" units or shares) or to acquire a large basket of units or shares ("create" units or shares).

Diversification

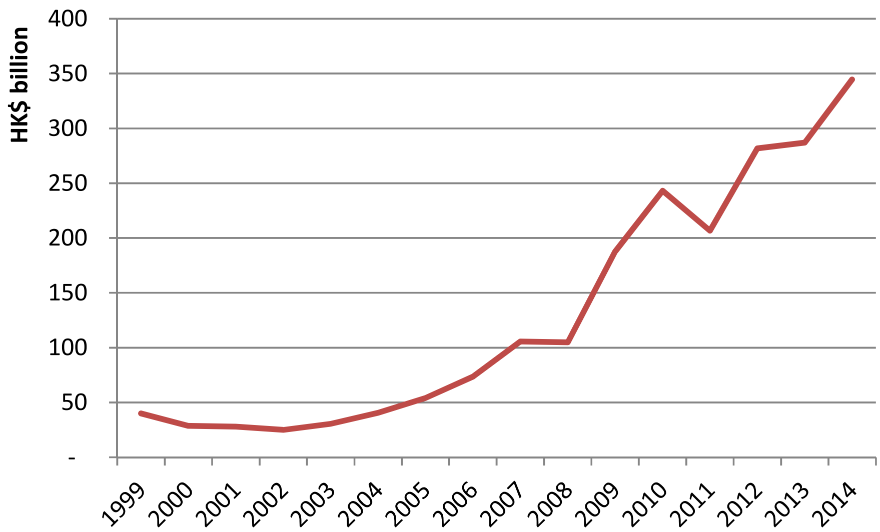
Most ETFs track a portfolio of assets across different sectors and geographical locations, providing diversified exposure to selected market themes. For instance, among equity ETFs, they can be further classified into global equity ETFs, regional equity ETFs, single-country ETFs or sector ETFs. In addition to equity ETFs which mostly track a major market index, there are also ETFs covering other asset classes, such as fixed income and commodity.

As one ETF can already give investors the exposure to a group of securities at relatively affordable cost, ETF serves as a handy investment tool for investors, particularly retail investors, to establish a balanced portfolio for risk diversification.

1.3 Hong Kong ETF market

According to the statistics from HKEx, as of September 2015 there were a total of 131 ETFs listed in Hong Kong, with a total market capitalisation of HK$340 billion (see Exhibits 2 and 3). There were 25 ETF issuers offering products tracking more than 100 different benchmarks, with 34 designated market makers to provide liquidity.

Exhibit 2: Market Capitalization of Hong Kong ETF market (1999-2014)*



**Market capitalization of SPDR Gold Trust is not included as it is listed on multiple exchanges. Source: Hong Kong Exchanges and Clearing Limited*

Exhibit 3: Market Cap and Turnover of ETFs listed on the Stock Exchange of Hong Kong Limited

Benchmark	# ETFs	Market Cap* HK$ Million	Market Cap %	Monthly T/O HK$ Million	Monthly T/O %
RQFII A-Share	16	55,462	16.3%	73,139	40.4%
Synthetic A-Share	24	76,925	22.6%	70,227	38.8%
Hong Kong Equity	20	147,420	43.4%	36,674	20.3%
Asia Pacific Equity	43	12,980	3.8%	402	0.2%
Other Equity	8	13,071	3.8%	121	0.1%
Fixed Income & Currency	9	32,918	9.7%	202	0.1%
Commodity	6	1,004	0.3%	163	0.1%
Total	126	339,779	100.0%	180,929	100.0%

**Market capitalization of SPDR Gold Trust is not included as it is listed on multiple exchanges. Source: ETF Market Perspective, Hong Kong Exchanges and Clearing Limited (March 2015)*

Hong Kong's ETF market has developed successfully over the past 15 years, currently listing 131 ETFs (as of September 2015) on a broad range of local and overseas underlyings in various asset classes and contributing some 8% of cash market turnover. This is compared to a percentage of cash equities turnover of approximately 10% and 25% in Europe and US respectively.[6] Hong Kong has an uniquely concentrated ETF market where a majority of capital are invested in just a handful of ETF products. Based on the HKEx's data available,

[6] Deutsche Bank, European Weekly ETF Market Review (April 2015)

the top five ETFs by turnover accounted for more than 95% of average daily turnover in March 2015. They were iShares FTSE A50 China, China Southern's CSOP FTSE China A50, the State Street-managed Tracker Fund of Hong Kong ("TraHK"), Hang Seng's tracker for the Hang Seng H-Share index of Hong Kong-listed Mainland Chinese companies and the ChinaAMC CSI300. Among them, iShares FTSE A50 China alone accounted for nearly 40% of turnover (see Exhibit 4).

Exhibit 4: Top 5 ETFs listed in Hong Kong by Turnover

Rank	Stock Code	Name of ETF	Turnover (HK$m)	Turnover(% of all ETFs*)
1	2823	iShares FTSE A50 China	67,497	37.3%
2	2822/82822	CSOP FTSE China A50	62,312	34.4%
3	2800	Tracker Fund of Hong Kong	21,035	11.6%
4	2828	Hang Seng H-Share	15,198	8.4%
5	3188/83188	ChinaAMC CSI300	10,234	5.7%

**Market capitalization of SPDR Gold Trust is not included as it is listed on multiple exchanges. Source: Hong Kong Exchanges and Clearing Limited (March 2015)*

Meanwhile, the top five ETFs measured by market capitalization represent more than 70% percent of assets according to data of HKEx as of March 2015 (see Exhibit 5). TraHK, iShares FTSE A50 China and CSOP FTSE China A50 went first, second and fourth respectively in terms of market capitalization. Hang Seng's tracker for the two main Hang Seng benchmarks of Hong Kong stocks came third and fifth.

Exhibit 5: Top 5 ETFs listed in Hong Kong by Market Capitalisation

Rank	Stock Code	Name of ETF	Market Capitalisation(HK$m)	Market Capitalisation(% of all ETFs)
1	2800	Tracker Fund of Hong Kong	66,362	19.5%
2	2823	iShares FTSE A50 China	65,622	19.3%
3	2833	Hang Seng	43,754	12.9%
4	2822/82822	CSOP FTSE China A50	34,905	10.3%
5	2828	Hang Seng H-Share	30,534	9.0%

Source: Hong Kong Exchanges and Clearing Limited (March 2015)

In other words, there is an absence of sizeable fund investing in securities other than Mainland China's A shares or Hong Kong-listed stocks (with the exception of ABF Pan Asia Bond ETF, which is a one-of-a-kind product with backing from regional governments). Added to the above, despite the heavy inclination towards the Mainland Chinese and Hong Kong market, HSBC de-listed all of its 4 ETFs in 2014 and all of them are Greater China-related.

The major ETF providers who operate successful ETF businesses are seen as a result of their early entry to market. A survey has been conducted in this regard and the number of major players running ETF products in markets other than in Hong Kong is little. The most important reason suggested in the survey was the difficulty in distributing ETFs in Hong Kong.

In general, most retail investors in Hong Kong are not acquainted with the benfit of investing in ETFs in portfolio diversification and risk reduction. Individual stocks and derivatives such as warrants and callable bull/bear contracts (CBBCs) are proven to be more popular to retail investors as it provides higher volatility. Liquidity and transparency of the ETFs are also major concerns for retail investors.

1.4 Global ETF market

The first ever ETF was the Toronto Index Participation Fund (TIP 35) which was listed in Canada in 1990. The US ETF market has since taken over and become the largest in terms of asset under management ("AUM") globally. The first ETF listed in the US was the SPDR S&P 500 ETF, which was listed on the New York Stock Exchange in 1993. Asia (ex. Japan) followed in the 1990s. TraHK was listed in Hong Kong in 1999. In Europe, iShares STOXX Europe 50 UCITS ETF and iShares Euro Stoxx 50 UCITS ETF were launched in 2000 (see Exhibit 6).

The global ETF market has experienced significant growth in the past 25 years, with over 20 countries setting up legislations regulating ETFs. In Asia, the first ETF was listed in Japan in 1995, followed by Hong Kong in 1999 and Singapore in 2001. Currently many Asian countries, including Mainland China, Korea, Taiwan, Thailand, Malaysia, have built their ETF markets with the strong support from the government.

Exhibit 6: A brief history of exchange trade funds

Timeline	Events
1990	First ETF in the world – Toronto Index Participation Fund was listed.
1993	SPDR S&P 500 ETF was first listed in the US.
1995	Nikkei 300 Stock Index Listed Fund became the first ETF listed in Japan.
1999	Tracker Fund was listed in Hong Kong.
2000	First ETFs in Europe – iShares Stoxx Europe 50 UCITS ETF and iShares Euro Stoxx 50 UCITS ETF were launched.
2001	First four ETFs were listed were listed in Singapore Exchange.
2004	First ETF in Mainland China – China 50 ETF was launched by China AMC.

Global ETF assets

ETFs have achieved a trend of very solid growth. Global ETF assets reached a figure of US$2.3 trillion in 2013, with both cash inflow and increases in asset prices contributing equally to the 28.2% year-on-year growth. Exhibits 7 and 8 show the global ETF asset growth rate across various regions and asset classes.

Exhibit 7: Global ETF asset growth rate per region from 2008 to 2013

	Global		US		Europe		Asia Pacific		Rest of the World	
	AUM ($B)	*Growth*	*AUM ($B)*	*Growth*	*AUM ($B)*	*Growth*	*AUM ($B)*	*Growth*	*AUM ($B)*	*Growth*
2013	2253.8	28.2%	1614.4	33.0%	396.6	18.6%	167.4	23.8%	75.4	2.3%
2012	1757.4	29.8%	1214.2	29.3%	334.3	23.8%	135.2	49.1%	73.7	36.0%
2011	1354.3	3.1%	939.3	5.1%	270.1	-4.8%	90.7	6.8%	54.2	5.0%
2010	1313.4	26.2%	893.3	26.5%	283.6	25.0%	84.9	30.4%	51.6	21.1%
2009	1040.9	42.9%	706.3	36.8%	226.9	64.8%	65.1	22.6%	42.6	100.0%
2008	728.4		516.3		137.7		53.1		21.3	
	Avg Growth	*25.3%*	*Avg Growth*	*25.6%*	*Avg Growth*	*23.6%*	*Avg Growth*	*25.8%*	*Avg Growth*	*28.8%*

Source: SFC, "Asset Management: Looking Forward", Deutsche Bank, "ETF Annual Review & Outlook – Eyeing $3 Assets Milestone in 2014"

Exhibit 8: Global ETF asset growth rate attribution across regions and asset classes in 2013

	Global			US			Europe			Asia Pacific			Rest of the World		
	Growth	*$ Flow*	*Px*	*Growth*	*$ Flow*	*Px*	*Growth*	*$ Flow*	*Px*	*Growth*	*$ Flow*	*Px*	*Growth*	*$ Flow*	*Px*
Equity	**36.7%**	17.7%	19.0%	**41.8%**	21.2%	20.6%	**28.6%**	8.9%	19.7%	**24.7%**	11.6%	13.1%	**6.1%**	7.2%	-1.1%
Fixed Income	**3.7%**	6.8%	-3.1%	**-0.3%**	3.8%	-4.1%	**16.9%**	15.1%	1.8%	**26.9%**	23.7%	3.2%	**-0.8%**	9.8%	-10.6%
Commodity	**-40.7%**	-19.3%	-21.4%	**N/A**	N/A	N/A	**-42.0%**	-19.3%	-22.7%	**-20.5%**	0.7%	-21.2%	**-44.7%**	-36.5%	-8.2%
Currency	**41.9%**	48.1%	-6.2%	**56.3%**	64.9%	-8.6%	**-69.8%**	-72.1%	2.3%	**49.0%**	49.4%	-0.4%	**232.9%**	244.0%	-11.1%
Multi Asset	**56.7%**	50.2%	6.5%	**62.9%**	55.5%	7.4%	**34.6%**	23.4%	11.2%	**42.1%**	47.2%	-5.1%	**30.9%**	30.3%	0.6%
Alternative	**27.7%**	22.5%	5.2%	**85.8%**	71.6%	14.2%	**0.1%**	-8.8%	8.9%	**-23.5%**	64.4%	-87.9%	**82.9%**	335.5%	-252.6%
Total	**28.2%**	**14.7%**	**13.5%**	**32.9%**	**17.6%**	**15.3%**	**18.7%**	**7.2%**	**11.5%**	**23.8%**	**12.0%**	**11.8%**	**2.3%**	**6.2%**	**-3.9%**

Source: SFC, "Asset Management: Looking Forward", Deutsche Bank, "ETF Annual Review & Outlook – Eyeing $3 Assets Milestone in 2014"

The majority of ETF listings and trading takes place in key developed markets that are open to international capital flow. Cross-border capital flow plays an important role in the development and success of an ETF market. Exhibit 9 shows the top 8 exchanges for ETF turnover in US$ billion in 2013.

Exhibit 9: Top 8 Exchanges for ETF turnover in USD billion in 2013

Ranking	Exchange	ETF T/O (USD billion)		No. of ETF Listings	
		2013	As of Sept 2014	As of Sept 2014	Ytd Chg
1	NASDAQ OMX	6,696	5,050	142	+20
2	NYSE Euronext (US)	3,589	2,098	1,481	+74
3	London Stock Exchange	258	209	736	+8
4	Japan Exchange Group	237	200	181	+12
5	Korea Exchange	179	123	166	+20
6	Deutsche Börse	163	130	1,029	0
7	Hong Kong Stock Exchange	116	84	121	+5
8	Shanghai Stock Exchange	109	74	59	+12

Source: SFC, "Asset Management: Looking Forward", World Federation of Exchanges, London Stock Exchange and SFC R&S Research

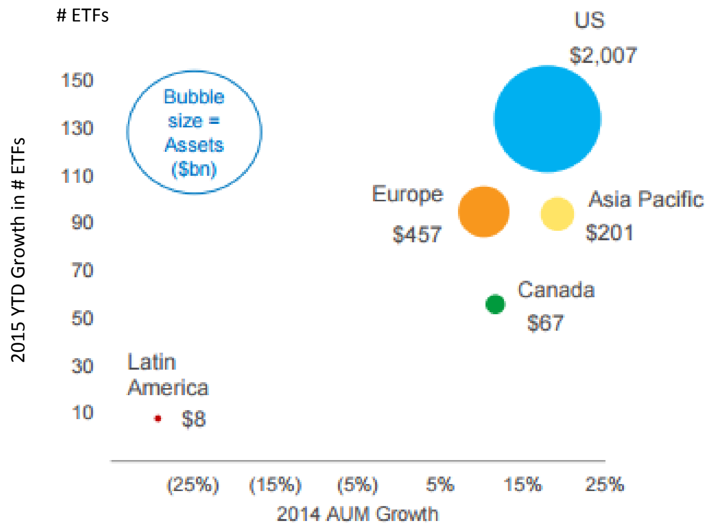
It is worth noting that ETF has become a highly successful tool for investment in the US and Europe. In the US alone, ETF assets represent more than 70% of the global total (see Exhibit 10). While annual growth may have slowed down from its ten-year average of more than 25%, the US market is still expected to expand by more than 15% annually – hardly a sign of maturity (see Exhibit 11). It is also notable that a significant proportion of US ETF inflows represent inward investment from Europe, Asia (including Hong Kong) and elsewhere.

Exhibit 10: Exchange-Traded Products by listing regions

By Listing Region	Net Flows ($bn) Mar 2015	Net Flows ($bn) YTD 2015	Mar 2015 Assets ($bn)	% Asset Market Share	Number of Products
US	26.8	56.3	2,097.3	71.5	1,688
Europe	7.6	34.2	494.0	16.8	2,269
Canada	2.1	3.7	65.8	2.2	362
Latin America	(0.3)	(0.2)	7.1	0.2	47
Asia Pacific	(0.1)	3.2	214.5	7.3	753
Middle East and Africa	Not Available	Not Available	53.9	1.8	378
Global ETP Total	**36.1**	**97.2**	**2,932.6**	**100.0**	**5,497**

Source: Blackrock ETF Landscape – Monthly Industry Highlights (March 2015)

Exhibit 11: Asset growth rates and the number of ETFs



Source: Blackrock ETF Landscape – Monthly Industry Highlights (December 2014)

In comparison to the US, ETFs in many developing markets are still in their infancy. Asia Pacific has the biggest growth in the world among other regions with assets expected to continue expanding at 20% to 30% per annum. Even so, the region is highly fragmented and there are significant local variations. In terms of AUM Japan's ETF market is the largest in Asia at US$111 billion as of April 2015 (see Exhibit 12). The total amount of AUM in ETF markets in the Asia ex-Japan market increased from US$27 billion in 2007 to US$201.1 billion in 2014. Japan is the region's largest and best established market, while Hong Kong continues to be the region's largest hub for offshore investment and Korea has an increasingly innovative domestic ETF market where leveraged products are very popular. Most other markets in the region are at an early stage of development, with rival promoters occasionally co-operating to build awareness of the benefits of ETFs.

Exhibit 12: Rankings of ETF Market in Asia-Pacific

Turnover

	Exchange	2015 YTD turnover (US$ millions)
1	Tokyo	111,630
2	Shanghai	111,378
3	**Hong Kong**	**68,934**
4	Shenzhen	37,703
5	Korea	35,933

AUM

	Exchange	AUM (US$ millions)
1	Japan	110,579
2	**Hong Kong**	**45,709**
3	Mainland China	38,160
4	Korea	19,078
5	Australia	8,562

6	Taiwan	7,862
7	Australia	2,906
8	Singapore	606
9	NSE India	538
10	BSE India	78

Source: World Federation of Exchanges, as of end of Mar 2015

6	Taiwan	5,107
7	India	2,419
8	Singapore	1,730
9	New Zealand	318
10	Malaysia	296

Source: Deutsche Bank, Bloomberg, Reuters, as of April 2015

In contrast, the European ETF industry is somewhat of a hybrid. As a region, it is expected to continue growing at 15% to 20% a year. In many ways it is as sophisticated as the US market, especially in the institutional arena. But while it enjoys some common standards, it is far more fragmented than the US market, and the proportion of retail take–up is far lower (e.g. the mix between retail and institutional investors is approximately 50/50 in the US compared to 20/80 in Europe). As we shall see, European ETF players would like to iron out these differences and start capturing more of the retail investor market.

While ETFs are out–growing the wider asset management industry in every region, it is important to remember that cross–border flows of capital play a significant role. It is also increasingly obvious that every market will follow its own development path. Nonetheless, there is global recognition that ETF growth can only be achieved with the right supporting circumstances and infrastructure.

1.5 Key success factors for ETF markets in the US and Europe

The reasons that ETFs are successful in the US and Europe can be summarized as follows:

Fee-based advisory growth

A fee-based advisory model aligns advisors' interest with the investors' interest and this allows investors to have a fair exposure to all sorts of funds/ETFs that may suit their overall investment needs. There is a trend toward fee-based advisory models where advisors are compensated on total assets under management as opposed to commission. This is aligning clients' and advisors' focus on low-cost products such as ETFs. In addition, scrutiny of investment related fees has grown as regulators worldwide step up financial oversight in the wake of the financial crisis. In markets such as the UK and Australia, regulations on pricing are driving a transition to fee-based advisory. In the US, proposals to limit 12b-1 fees[7] could further level the playing field for ETFs versus conventional unlisted funds. Limitations on mutual fund distribution fees would mean less money for conventional fund promotion, and could therefore support accelerated ETF growth.

Regulatory emphasis on transparency

All indicators suggest that regulators will continue to demand greater disclosure from asset managers, especially in matter of pricing. As ETFs offer comparatively simple pricing structures compared to many other asset management products, they should have an advantage over traditional funds in an era of greater transparency.

Rising investor awareness

ETFs have delivered impressive growth despite still relatively low awareness and adoption among investors, advisors and institutions – implying that significant growth potential remains. According to the report named The Second Act Begins for ETFs published by McKinsey & Company, about 15% of institutional investors say they are not sufficiently familiar with ETFs or do not use them at all. Another 35% say they are familiar with ETFs, but do not own or use them. In the retail channel, 40% of advisors say the same. Awareness and adoption of ETFs will continue to rise as more well-recognized fund names enter the market with both passive and active ETF products. ETF issuers are also active in content marketing to increase investors' awareness of ETFs.

In US and Europe, there has been a lot of media and regulatory attention on "closet indexers" in recent years. A closet indexer is a fund manager that mimics the index, or benchmark that he or she is assigned to outperform. For example, if a fund manager has the same holdings as the S&P 500, thus the same performance, he or she would be a closet indexer. The problem is that it charges relatively high fees for what is essentially a generic portfolio. Increasing the understanding of "closet index funds" encourages more investors pull money from active funds in favor of ETFs.

Increased institutional appetite

While hedge funds and money managers have been actively researching on and investing in ETFs for some time, institutions such as defined benefit (DB) and defined contribution (DC) pension plan sponsors, endowments and foundations are only beginning to indicate interest in ETFs. ETFs offer institutions benefits including the flexibility to easily maintain benchmark exposure while switching managers or deciding how to deploy cash (i.e. cash

[7] 12b-1 fees, also known as distribution fees, are one component of a mutual fund's annual fund operating expenses and can be thought of as an alternate way of paying sales-related expenses, such as compensating investment professionals.

equitisation). More importantly, ETFs also fit naturally into core-satellite strategies that are popular with institutions. Larger institutions can often also realize cost savings with ETFs, thanks to their ability to generate extra yield through ETF lending. Underlying the growth of ETFs are four factors that will change the industry landscape significantly going forward: (i) an increasingly competitive market for passive investments; (ii) growth in active ETFs; (iii) globalization of the marketplace; and (iv) new competitive models.

Section 2 Benefits of a thriving ETF market

Hong Kong has the ideal financial structure and talents to support a thriving ETF market. As one of the most buoyant ETF markets in the region, Hong Kong benefits from the following:

1. Fortifying Hong Kong as the region's centre for financial and capital markets;
2. Strengthening Hong Kong as a global capital formation centre by becoming the listing venue of choice for Mainland Chinese and other overseas issuers and attracting international institutional investors to our platform;
3. Attracting ETF analysts and global ETF talents to Hong Kong by the clustering effect. This will enhance the width and depth of analyst coverage on ETFs, industry practitioners' standards and corporate governance;
4. Further enhancing Hong Kong's capital markets as ETFs are frequent capital market users, thus market participants will introduce more innovative fund raisings by ETFs; and
5. Provide more investment chocies to Hong Kong's investing public.

2.1 Fortifying Hong Kong's market position

The global asset management industry experienced stable growth since the Global Financial Crisis (GFC). AUM reached US$68.7 trillion globally in 2013 while AUM in the Asia Pacific region reached US$10.6 trillion, 42% of which originated from Asia ex-Australia and Japan. Despite the comparatively smaller AUM size of US$4.4 trillion, Asia ex-Australia and Japan had a higher average annual growth rate than the rest of the world, at an average of 16% per year since 2008. Exhibit 13 shows AUM growth trends globally and regionally since the GFC.

Exhibit 13: AUM sizes and growth rates from 2008 to 2013

	Global		North America		Latin America		Europe		Middle East and Africa		Australia and Japan		Asia ex AU and JP	
	AUM ($T)	*Growth*	*AUM ($T)*	*Growth*	*AUM ($T)*	*Growth*	*AUM ($T)*	*Growth*	*AUM ($T)*	*Growth*	*AUM ($T)*	*Growth*	*AUM ($T)*	*Growth*
2013	68.7	*12.8%*	34.0	*15.6%*	1.7	*13.3%*	19.3	*7.2%*	1.4	*16.7%*	6.2	*19.2%*	4.4	*15.8%*
2012	60.9	*6.8%*	29.4	*6.1%*	1.5	*15.4%*	18.0	*11.1%*	1.2	*9.1%*	5.2	*-11.9%*	3.8	*18.8%*
2011	57.0	*1.1%*	27.7	*0.4%*	1.3	*0.0%*	16.2	*-3.0%*	1.1	*10.0%*	5.9	*11.3%*	3.2	*10.3%*
2010	56.4	*7.6%*	27.6	*8.2%*	1.3	*18.2%*	16.7	*7.1%*	1.0	*0.0%*	5.3	*1.9%*	2.9	*11.5%*
2009	52.4	*12.7%*	25.5	*13.3%*	1.1	*22.2%*	15.6	*10.6%*	1.0	*25.0%*	5.2	*8.3%*	2.6	*23.8%*
2008	46.5		22.5		0.9		14.1		0.8		4.8		2.1	
	Avg Growth	*8.1%*	*Avg Growth*	*8.6%*	*Avg Growth*	*13.6%*	*Avg Growth*	*6.5%*	*Avg Growth*	*11.8%*	*Avg Growth*	*5.3%*	*Avg Growth*	*15.9%*

Source: SFC, "Asset Management: Looking Forward", Boston Consulting Group, "Global Asset Management Report" 2011-2014 and SFC R&S Research

ETFs were first created with the objective of enabling investors to invest in an index-tracking tool listed on an exchange in a cost effective manner, with high liquidity and transparency. Since then, ETFs have attracted investments from retail and institutional investors, especially those with the concept of asset allocation and understanding the benefits of passive investing.

One of the potentially biggest sources of funds investing into ETFs is pension funds. With Asia accounting for 60% of the world's population, the growth of pension funds in Asia over the coming decades will be phenomenal. Asian pension funds are estimated to double their assets over 2006-2015 to US$2.4 trillion (see Exhibit 14), and further increasing to US$4.3 trillion by 2030. The most significant growth in market share will be in Mainland China, South Korea and India.

Exhibit 14: Expected Growth in Asian Pension Fund Assets 2006-2015

	Assets		Percentage of Asian assets	
Country	**2006**	**2015**	**2006**	**2015**
Mainland China	$89B	$581B	8%	25%
Hong Kong	$60B	$142B	5%	6%
India	$57B	$227B	5%	10%
Japan	$789B	$862B	69%	36%
Singapore	$92B	$155B	8%	7%
South Korea	$45B	$286B	4%	12%
Taiwan	$6B	$52B	1%	2%
Thailand	$13B	$66B	1%	3%
Total	$1,151B	$2,371B	100%	100%

Source: FSDC (Research Paper No. 4: "Developing Hong Kong as a Capital Formation Centre for Real Estate Investment Trust")

In addition to the growth of pension funds in Asia, the industry is also undergoing a fundamental shift in its investment strategy. Traditionally, pension funds in Asia focus their asset allocation on domestic fixed income assets. But these funds are gradually constructing a portfolio comprising sizeable global assets through low cost vehicles like fixed income ETFs or even equity ETFs, which offers a flexible and convenient way of diversifying their portfolios.

2.2 Strengthening Hong Kong as a global capital formation centre

Despite the 131 ETFs listed in Hong Kong as of September 2015, only a handful of ETFs attract larger investment from investors. A large amount of assets are invested in Mainland

China-related ETFs, especially A share ETFs. ETFs are being overlooked as a potential tool to attract foreign capital.

Currently more than US$300 billion assets globally are invested in ETFs with exposure to Asian assets, however most of these ETFs are listed in the US. This potentially is a significant growth opportunity for Hong Kong if it is able to attract such investments from other places to Hong Kong listed ETFs. To achieve this, Hong Kong will need to provide an optimal regulatory environment for ETF investors.

2.3 Cluster effect

As more ETFs are listed in Hong Kong, more investment analysts and ETF specialists will be needed to cover these ETFs. Brokerage services will also benefit from the increase in trading volume of the stock market.

Asset management market will also develop and grow to cope with the growing investment need. Such growth will enhance the skills and sophistication of fund managers in managing alternative investment products, broadening the range of investment products they can offer to the public.

An expanded ETF market will also give rise an increased volume of advisory work form a range of professionals. Lawyers, accountants, trustees and custodians will benefit from an increasing demand of their services.

Currently, only a few ETFs are used by ETF-related derivatives issuers as underlying assets. An increased demand for ETFs will also give rise to more warrants, CBBCs and equity linked products in Hong Kong and these help further boosting Hong Kong's capital market industry.

2.4 Hedge funds' use of ETFs

Traditonally, hedge funds use ETFs more as a hedging tool than as a directional investment vehicle. Lower fees and ease of trading and, in some cases, tax advantages are well known reasons. Investment performance is another one. In the US, less than 10 percent of active managers beat the S&P 500. And it is difficult to add alpha by picking stocks, bonds and commodities. As hedge funds become more familiar and comfortable with investing in ETFs, the usage of ETFs as an investment tool has evolved from tactical to core allocations, and further to risk management and portfolio rebalancing purposes.

Section 3 Proposed solutions

3.1 Improve investor education in ETF

In the last 2 years the US and EU markets have performed well, but this has not led to greater use of ETFs listed on the SEHK investing in either or both of these markets. At present, there are only two SFC authorized ETFs that invest in either Europe or the US. Many investors, especially retail investors, are not aware of the possibility of investing in these two markets through ETFs. Therefore, investor education in ETF is of utmost importance to raise Hong Kong investors' awareness of the possibility of investing in overseas equity ETFs.

A website that is of useful reference on ETFs is the "Understand ETFs" website which was commissioned by ETF providers in the US to provide ETF content to investors for education purpose:- http://www.understandetfs.org/about.html

Investor education is an important aspect for the development of ETFs in Hong Kong. The strategy of using ETFs as a low cost way to implement a strategic asset allocation is not well-known or commonly used among Hong Kong investors/advisors. For a business to grow, the prerequisite is for there to be a demand for the business. Hence, it is important to ensure that investors are aware of the benefits and the needs in investing in ETFs. The benefits of using ETFs as a tool to gain diversified exposure to a range of stocks for long term investment or for tactical purposes (eg. investing in an ETF specifialising on a sector / industry/ country / region) should be promoted. We recommend a joint effort by ETF issuers, distributors, the SFC, the SEHK and the government to be made to promote investor education on ETFs.

Investor education is critically important to the growth and innovation of ETFs. Successful ETF firms continue to invest significant time and resources in educating their internal sales, marketing, legal compliance and treasury personnel on key product features. In turn, these successful ETF firms also invest significant time and resources to educate their investors and potential investors on how ETFs can be used. It is important to have strong support in the market from the ETF service providers and third party professionals. Creating effective and efficient trading and settlement processes between authorized participants, exchanges, service providers and ETF sponsors is also very important to facilitate an effective and efficient trading process for ETFs.

3.2 Promote the usage for ETFs in the MPF platform

According to studies conducted by Greenwich Associates, about one third of the largest public defined-benefit pension funds (those with at least US$5 billion in AUM) and roughly 25% of the largest corporate defined benefit funds in the US invest in ETFs in their portfolios. In Europe, about 28% of public and corporate pension funds use ETFs versus 19% for corporate pension funds. Most pension fund users allocate between 1% and 10% of their portfolio to ETFs, and about one in five pension funds allocate 11% to 25% of their portfolio to ETFs.

Although ETFs first entered institutional portfolios mainly as tactical tools, many institutions including pensions has indicated that they had began to regularly use ETFs for many additional purposes, including to gain long-term exposures and to implement investment strategies. For instance, European pension funds hold ETFs for an average of 29 months, according to the survey conducted by Greenwich Associates.

Moreover, according to a study of MPF administrative costs published by Ernst & Young in November 2012[8], Hong Kong's MPF system has the highest fees and administration costs when compared to other international pension systems such as Australia, Chile, Mexico and the USA. One of the major reasons given was the prevalence of manual and paper–based administration processing in Hong Kong's MPF platform.

Using online solutions for member enrolment and contribution, and implementing electronic payments would enable administration processing at a lower cost and lower process error rates. In addition, an online platform would reduce costs by enabling straight-through processing and standardization of data and processes.

The good news is that efforts have also been made to reduce the overall fund expense ratio charged on MPF members. The Mandatory Provident Fund Schemes Authority (MPFA) obtained good support in a public consultation for a proposal to procure all MPF providers introduce a so-called "core fund" option for MPF members from as early as 2016. The funds would have a simple investment mix, with fees capped at 0.75 per cent.

We believe that the potential implementation of electronic platform and the introduction of "core fund" option would become the main drivers to increase the use of ETFs in the MPF platform due to its simple structure and its natural fit to regulators' initiative to lower the expense ratio of the funds in Hong Kong's MPF system.

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[8] Ernst & Young, Managing the changing landscape of retirement savings
http://www.mpfa.org.hk/eng/information_centre/publications/research_reports/files/MPF%20Consultancy%20Study%20Report(Eng).pdf

As of 23 September 2015, there are 117 ETFs approved as ITCIS, of which 35are listed on the SEHK. The remaining 82 ETFs are listed overseas.[9] However, according to industry survey, less than 10% of the MPF assets are invested in the approved ITCIS. The ETF assets of the approved ITCIS also showed strong home country bias as the majority of the investment concentrate their investment on the Hong Kong stock market.

In order to increase ETF usage and readiness of enhancing the infrastructure in the MPF platform as mentioned above, there is a common belief within the ETF industry that MPFA would relax its guidelines for the use of ETF products listed on the SEHK. There are many low-cost ETFs which could potentially be added to the ITCIS list but they are currently prevented from gaining ITCIS approval due to various restrictions. It is our understanding that MPFA keeps an open-mind about broadening existing perimiters to align themselves with global practice for the use of ETFs in pension systems. We hope that soon Hong Kong will have an MPF platform that has a more diversified range of products at a lower cost for MPF members and MPF providers.

3.3 ETF Mutual Recognition and Shanghai-Hong Kong Stock Connect Scheme

Many ETF issuers agree that inclusion of ETFs in the Mutual Recognition of Funds between Mainland China and Hong Kong is a catalyst to the growth of ETFs listed in Hong Kong. Even more of a potential “game changer” would be to include ETFs as investible securities under the Shanghai-Hong Kong Stock Connect Scheme for “Southbound” investment. We believe the capital outflow from Mainland China will first benefit Hong Kong listed ETFs as Mainland Chinese investors can easily get international exposure through Hong Kong’s ETFs. This can help improve the liquidity and AUM, which are seen as the most critical issues for the growth of ETFs. While the lack of distribution channels remains a challenge, a regional fund passport in Asia could also create a substantial impact on the success of ETFs.

If ETFs were to be included in the future Stock Connect Schemes, we expect a large number of “captive” south bound Mainland Chinese investors will invest in Hong Kong-listed ETFs as Mainland Chinese investors are not permitted to invest in ETFs in other overseas markets directly. The “capitive” capital will pose enormous opportunities for Hong Kong-listed ETFs.

From Mainland China’s perspective, Stock Connect Schemes can also attract enormous inflow of foreign capital through Hong Kong to invest its larger variety of China-themed ETFs

[9] List of Approved Index-Tracking Collective Investment Schemes (“ITCIS”): http://www.mpfa.org.hk/eng/information_centre/useful_lists/index_tracking_collective_investment_schemes/itlist.do

that are available on the Shanghai and Shenzhen stock exchanges. Therefore, Stock Connect Schemes will bring mutual benefits to both Hong Kong and Mainland China.

3.4 Enhance communication between the industry and the SFC

In order to ensure Hong Kong is welcomed as a regional and global hub for capital formation for ETF listings, it is important that applications to the SFC and SEHK for authorization and listing respectively are handled efficient and timely, but at the same time investor protection is not jeapardized.

In this respect, the industry's understanding of the SFC's authorization process and the regulatory requirements is critical to encourage listings and to facilitate innovation.

ETFs are, by their nature, a low cost investment product where product manufacturers are constantly striving to reduce the total expense. Achieving efficiencies in the authorization process will therefore also produce cost savings and encourage more new ETF products to be created by ETF managers.

We encourage an open and frequent dialogue between the ETF industry and the SFC to ensure future growth of the ETF market in Hong Kong. We understand that the SFC is currently working on revamping the authorization process to streamline certain types of applications. SFC will continue to maintain an open dialogue with the industry.

3.5 Improving ETF distribution channels

As mentioned previously, we believe that distribution is one of the game changers in ETF industry. Currently, intermediaries and distributors are mostly commission driven. Hence, it is difficult for ETFs to be able to pay rebates / retrocessions to distributors who sell ETFs, given the low fee feature of ETFs. The US sees a higher participation to retail investors compared to other countries because it has a fee-based advisory practice and advisors are keen to use ETFs as low cost investment vehicles to create portfolios for their clients. Retail advisers are then able to use ETFs as a low cost way to achieve a strategic asset allocation. Such working relationship is not common in retail market in Hong Kong or in other retail markets in Asia.

For several years, wealth managers and product distributors have been pressing on fund managers for a larger share of revenue. As most ETFs do not currently pay fees to the distribution channel, they allow fund managers to essentially distribute "for free" and avoid some distribution induced margin pressure. While this free ride is attractive for the moment, it hampers the growth of ETF in the larger purview of the market. Wealth managers are also starting to take seriously the threat to their business model and press for a piece of the ETF revenue stream from ETF managers. In the world of free economy, we think it is likely that wealth managers would ultimately succeed in these efforts in getting a share of the profit and that this would improve the current ETF distribution network.

3.6 Nurture local expertise and talent to develop Hong Kong into an ETF manufacturing hub

In order to develop Hong Kong as one of a world leading ETF markets, simply encouraging cross-listing of overseas ETF in Hong Kong would not be sufficient. While distribution is crucial to the development of ETFs in Hong Kong, it is equally important for local issuers to develop innovative ETFs to attract investors from Mainland China and overseas markets. Unfortunately, the current ETF market in Hong Kong lacks the infrastructure to nurture local talent to compete with international asset managers in Hong Kong. Only 12 of the total 126 ETFs listed in Hong Kong are managed by local issuers that do not belong to subsidiaries of an overseas or Mainland Chinese asset managers. The regulators should consider initiatives to encourage local asset managers to put effort and resources in developing their ETF businesses and creating innovative products for local and overseas investors.

3.7 Broaden the product range – ETF cross-listing

Cross-listing ETFs from overseas markets is one of the ways to expand the ETF market in Hong Kong. For ETF issuers, it may be commercially unattractive to build and launch new ETFs specifically for the Hong Kong market since it may be difficult to raise sufficient initial capital and to build up a critical mass of AUM. The industry believe the Mutual Recognition of Funds between Mainland China and Hong Kong will improve the attractiveness of Hong Kong as an ETF platform.

Cross-listing would be a convenient, efficient and economical way to bring new ETFs to Hong Kong, leveraging on existing successful ETFs' global AUM and branding. Noteably, cross-listing of ETFs is common in Europe.

Currently, only 36 out of 126 ETFs are cross-listed from overseas – the largest being db X-trackers Luxembourg UCITS range. There are no major barriers to the cross-listing of Undertakings for Collective Investment in Transferable Securities (UCITS) ETFs. The main challenge for cross listing is that an ETF has to satisfy both the regulation in the home jurisdiction as well as those in Hong Kong. The SFC issued a circular on the streamlined measures for processing UCITS application in March 2007. To further enhance the cross-listing of UCITS ETFs, the SFC should consider working with the Irish and Luxembourg regulators on relaxing some dual compliance requirements.

It is also noteworthy that, although allowed by the ETF Guidelines in the SFC's Code on Unit Trusts and Mutual Funds, to date the SFC has not announced and the recognition of any "acceptable ETF regimes" to stream-line cross listings. On the good side, the SFC has entered into mutual recognition of funds arrangements with Australia, Taiwan, Malaysia and the Mainland, covering ETF products.

Another feature is that stock lending (a practice of many overseas ETFs) is not prohibited in Hong Kong. The SFC's recently-issued FAQ provides guidance, stating among other things that a stock lending level of up to 30% is considered acceptable.

To support cross listing of ETFs on the SEHK, the SFC should enter into memorandums of understanding on inspection and compliance standards with equivalent overseas regulators but not with overseas exchanges. There also needs to be an efficient settlement and clearing linkage between HKSCC and the respective overseas clearing house / depository. ETF issuers need to be prepared to build a value chain in Hong Kong to deliver the needed services in a prompt manner. There are substantial practical and structural difficulties that must be overcome before the benefits of cross listing ETFs would materialise.

To conclude, we acknowledge that the current cross-listed ETFs in Hong Kong are the product of intensive efforts by the SFC and the respective overseas regulators to overcome the difficulties involved. While the SFC remains committed to continuing these efforts, it must be satisfied that investor protection and market integrity are not compromised.

3.8 Consider the use of depository receipt schemes and grantor trusts

As in the case of other regional competitors such as Japan and Singapore, Hong Kong allows the original prospectus of cross-listed ETFs to be used with some local wrappers. On an ongoing basis, overseas ETF is required to obtain SFC approval before making certain material changes to the ETF's documentation.

Some overseas markets such as Japan, Mexico, Brazil and Chile have adopted depository receipt (DR) schemes to facilitate overseas ETFs to cross-list locally. Country by country mutual recognition requires translation of all home regulations into English and clause by clause comparison of the regulatory frameworks to ensure that they are equivalent to that of Hong Kong. This would deter ETFs from small markets to attempt any cross-listing in Hong Kong

As for grantor trusts (a legal structure adopted by some major US ETFs which does not have a fund manager), under the current regime it is permissible to be cross-listed provided that there is a Hong Kong licensed firm willing to assume additional duties akin to that of a licensed fund manager so that the SFC has a regulated person answerable to it for the ETF. We understand that the SFC is open to consider the cross-listing of US grantor trusts on a case-by-case basis. Some industry players, however, have observed that withholding tax issues would have to be resolved for such cross-listed grantor trusts to be commercially attractive.

3.9 Develop innovative benchmark indices

Although the major index providers already have many choices of index products that cover most markets, sectors and themes, ETF providers should persuade the established index provider to launch new indexes if they see a market and demand in them. It is observed that the current limited choices of ETFs available in the market is mainly due to the lack of demand and the stringent approval procedures of the SFC.

On the other hand, the Securities and Exchange Commission in the US approved a rule last summer allowing asset managers to create their own indices without any involvement of indexing companies. This policy could put pressure on index licensing fees and reduce costs to investors, and thereby enhance the development of the ETF market. We note that the Unit Trust Code does not prevent managers from creating their own indices. All indices, however, have to meet the requirements in the Unit Trust Code which include, amongst others, proper management of potential conflicts of interests, the sufficient capability of the manager and necessary expertise and technical resources. It is believed that SFC will continue to maintain an open dialogue with the industry in this regard.

3.10 Enhance classification of ETFs

We believe that insurance companies investing in ETFs should be able to treat ETFs as if it is investing into the underlying assets held by the ETFs. For example, a fixed income ETF should be grouped with bonds, not equities. The National Association of Insurance Commissioners in the US made a similar change with respect to the treatment of ETFs for statutory accounting purpose which significantly increased the level of interest by insurance companies in ETFs. If a fixed income ETF is treated as an equity, it would have negative implication from risk based capital perspective, which could prevent the insurance companies from investing in it.

3.11 Expand the Double Taxation Agreement network to other territories

Tax efficiency and tax treatment of distribution affects the yield of investment products. Hong Kong currently has concluded DTAs with around 30 countries / territories. The DTA network is relatively small when compared to other jurisdictions. Hong Kong should expedite its negotiation and conclusion of DTAs with other countries / territories.

We recognise that Hong Kong's DTA network is not large when compared with other major financial centres. However, we understand that this is an area the Hong Kong government is working to improve, as evidenced by the continual increased number of DTAs which are signed or in the pipeline. We think it is important for the Hong Kong government to develop a strategy or set clearer priorities as to the specific jurisdictions it would like to get DTAs signed in order to benefit listed ETFs in Hong Kong. In addition to actively pursuing or expediting the negotiation and conclusion of DTAs with other countries / territories, the focus should also be to ensure that the DTA clauses reflect the Hong Kong government's strategy or policy.

For example, to benefit listed ETFs in Hong Kong, the Hong Kong government may consider prioritising its DTA initiation / negotiation / conclusion process with those countries / territories which host the major stock exchanges in the world (by market capitalisation). However, we appreciate that DTAs are two-way, and would also very much depend also on the counterpart country / territory.

Section 4 Conclusion

ETFs present investors with a convenient means to gain exposure to a portfolio of stocks, bonds or commodities. ETFs have lower cost than unlisted mutual funds and are more liquid, with transparent pricing. Innovative ETFs offer a reasonably low-risk way to gain inverse or leveraged exposure to a portfolio. Overall, ETFs are effective investment tools, which has been reflected in the confidence with which investors worldwide, both retail and institutional, have embraced the sector.

Hong Kong's ETF market has developed successfully over the past 15 years. There are currently over 100 ETFs listed in Hong Kong with a broad range of local and overseas underlying assets in various classes, contributing to some 8% of the SEHK's cash market turnover. However, leading overseas markets have enhanced their ETF platforms recently, offering an even broader range of ETF products. Within Asia, Hong Kong's leadership position has been overtaken by Japan and Shanghai as they have introduced more innovative products. Hong Kong can look to design products based on the investors' demand - according to PWC's 2015 ETF survey[10], 46% of all survey participants identify the new types of indexing (also referred to as "smart beta") and 34% identify active ETFs as the two most important area of innovation.

There is demand from market users to expand the Hong Kong ETFs market base and opportunities exist for Hong Kong to regain its leadership position within the region. Hong Kong plays a unique role in Mainland China-Hong Kong financial cooperation and Mainland China's capital market reform. With an appropriate range of investment products, Hong Kong can potentially take a large share of ETF assets by attracting and retaining Mainland Chinese investment activities. With appropriate enhancements in its ETF regime there is capacity for Hong Kong to improve its position as the leading regional ETF hub.

[10] PwC Global ETF Survey, September 2014

About the Financial Services Development Council

The Hong Kong SAR Government announced in January 2013 the establishment of the Financial Services Development Council ("FSDC") as a high-level and cross-sector platform to engage the industry and formulate proposals to promote the further development of Hong Kong's financial services industry and map out the strategic direction for development. The FSDC advises the Government on areas related to diversifying the financial services industry, enhancing Hong Kong's position and functions as an international financial centre of our country and in the region, and further consolidating our competitiveness through leveraging the Mainland to become more global.

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