Corporate Outlook

The collapse of the US mortgage market four years ago has led to a financial crisis that continues to have a profound effect on the global economy and an unprecedented regulatory response. The crisis laid bare sheer size and interconnectedness of the global financial system, as well as the interdependence between the "real" economy and a highly complex financial infrastructure – ranging from banks to brokers and exchanges. Examples of the considerable regulatory effect now underway include proposals to insulate customers of systematically important financial institutions from the effects of financial stress (addressing the "too big to fail" problem) as well as a multitude of other global regulatory initiatives aimed at ensuring greater financial stability and the reduction of systemic risk.

These developments are of direct relevance to Hong Kong's development as an international financial centre (IFC), which functions as a location for fund raising and investing for local and, increasingly, overseas participants. This "hub" role underscores the importance of collaboration between Hong Kong regulators with their counterparts, regionally and around the world. Without this, it would be extremely difficult to regulate effectively the activities of large global firms as well as all other overseas participants in our markets.

The global regulatory agenda is packed, and risks impacting Hong Kong continue to have their epicenter outside the city.

Consequently, in the year ahead, we view Hong Kong's interaction with the international regulatory community – within Asia and globally – as a key area of focus, concentrating on financial stability, the reduction of systemic risks and implementing associated global and local initiatives.

Closer to home, we are addressing two equally important issues. The first is to foster the continued growth of Hong Kong's position as an IFC and to further develop the city as an a renminbi centre. The second is to implement a series of initiatives to enhance investor protection.

All of these objectives can only be achieved through close collaboration within the SFC itself across our internal divisions; to that end, we have formed a number of cross-divisional teams to work on key initiatives.

Focus 1: Hong Kong as an integral part of the global regulatory community

A large volume of the participants in Hong Kong's financial markets – listed companies, brokerages, funds and other sources of capital and liquidity – is international. This means that it is important that Hong Kong is able to absorb external shocks and also effectively regulate its markets through close co-operation with regulatory counterparts worldwide.

Global regulatory co-operation is relatively mature in the area of enforcement against market misconduct and financial crimes. However, the global financial crisis and its aftermath – from the collapse of Lehman Brothers to the failure of MF Global in 2011 – exposed the critical fact that close cross-border regulatory co-operation must also extend to the policy, risk and supervisory areas.

Shape the global regulatory policy agenda

A large number of international groups are involved in responding to the crisis, including the Group of Twenty, the Financial Stability Board (FSB), the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO).

Hong Kong's objective is to contribute meaningfully to the international regulatory agenda and to implement global regulatory objectives in a manner that is aligned with the international consensus and also sensitive to market realities.

We will continue to play an active role in the global regulatory dialogue, participating through IOSCO, the global securities markets standard setter and policy forum, and contributing to initiatives under the FSB:

- **Assisting in IOSCO work:** The SFC is an active member of the seven IOSCO standing committees and of key IOSCO task forces. It chairs the Standing Committee on the Regulation of Market Intermediaries and co-chairs the working group on margining requirements for non centrally cleared derivatives, a collaborative working group led by the FSB and comprising the Basel Committee on Banking Supervision, IOSCO, the Committee on Payment and Settlement Systems and the Committee on the Global Financial System.
- **Chairmanship in IOSCO:** Starting May 2013, the SFC will chair the Asia-Pacific Regional Committee of IOSCO, which is expected to take an increasingly proactive approach in the shaping of the global regulatory agenda.

Implement global regulatory reforms in Hong Kong

Reforms in the pipeline include:

- **OTC derivatives:** We aim to issue the consultation conclusions paper on a proposed over-the-counter (OTC) derivatives regulatory regime within the second quarter, table the enabling bill in the Legislative Council (LegCo) by the fourth quarter and launch another consultation on subsidiary legislation to implement the new regime in the second half of 2012. Meanwhile, the Hong Kong Monetary Authority (HKMA) and Hong Kong Exchanges and Clearing Ltd (HKEx) are respectively working towards establishing a trade repository and a new clearing house for OTC derivatives by the end of 2012.
- **Short position reporting:** The Securities and Futures (Short Position Reporting) Rules took effect on 18 June 2012; this allows us to monitor more effectively short selling activities, including detecting any significant build-up of short positions. From September 2012, we will publish reported short positions on an aggregated basis for each stock to increase overall market transparency.
- **Electronic trading:** We are formulating regulatory requirements for electronic trading, including Internet trading, algorithmic trading and direct market access. A public consultation on the proposed requirements is expected to be launched within 2012.

Actively participate in the global regulatory dialogue on systemic risk

In 2010, IOSCO adopted new core principles for regulators to identify, assess and mitigate systemic risk and to review their regulatory perimeters. Against this background, and in view of the emphasis now placed on financial stability and systemic risk within the global regulatory community, the SFC enhanced its existing risk assessment capability with the creation of a new risk and strategy (R&S) unit.

The R&S unit now takes part in the IOSCO's Standing Committee on Risk and Research, working on topics such as central clearing counterparties, high frequency trading, credit default swaps, structured product innovation, shadow banking and financial risk disclosure.

Within the SFC, the R&S unit will work closely with the operating units to determine principal risks facing the regulator and the markets, and to agree on measures to mitigate those risks.

The R&S unit will maintain an open and frequent dialogue with the financial industry.

Be part of greater global regulatory co-operation

As the financial crisis demonstrated, large financial institutions function globally. As a result, enhanced global co-operation is paramount and Hong Kong is part of this effort. For example, the IOSCO's Standing Committee on the Regulation of Market Intermediaries chaired by one of our senior directors, Mr Stephen Po, and the IOSCO's Task Force on Unregulated Financial Entities and the Task Force on Unregulated Financial Markets and Products in which we also participate, are working on the criteria to identify systemic issues involving brokers, the selling of structured products to retail customers and hedge funds.

As part of an IOSCO data collection exercise, the SFC will conduct a survey of licensed hedge fund managers and advisors in 2012.

Focus 2: Implement various initiatives to further investor protection

The challenging global economic environment continues to expose Hong Kong to volatility and risks (see Chairman's Message on pages 3-6). We also are dealing with risks arising from financial innovation and technological advances in trading. While encouraging market development, our key priority is to safeguard the interests of the investing public.

Listed company market

The quality of information issued by industry participants to the public is central to market integrity and investor protection under our disclosure-based regime. To that end, we are concluding a number of related reforms and will review other areas shortly.

- **Sponsors regime:** The sponsor guidelines we introduced in 2007 laid down specific requirements for sponsors to help raise their standards in connection with new listings. In May 2012, we launched a consultation containing a number of proposals aimed at maintaining a quality listing market in which investors can place a high level of confidence. The proposed changes to the Code of Conduct* will consolidate existing and new standards expected of sponsors to help ensure that they exercise reasonable judgment when conducting due diligence on listing applicants.

* Code of Conduct for Persons Licensed by or Registered with the SFC

- **Price-sensitive disclosure:** The Securities and Futures (Amendment) Ordinance 2012 was gazatted on 4 May 2012 to provide statutory backing to the obligations of listed companies and their senior management to announce price-sensitive developments. We have published a set of "Guidelines on Disclosure of Inside Information" to help listed corporations comply with the new requirements. The new law is expected to come into force on 1 January 2013. We are also exploring with HKEx a trading halt policy to allow publication of price-sensitive announcements during trading hours.
- **Overseas listings:** The number of listing applications from non-Mainland overseas companies is on the rise. We continue to work with The Stock Exchange of Hong Kong Ltd (SEHK) to review the listing approach to overseas companies seeking primary or secondary listings to facilitate this important sector as well as address investor protection concerns. It is anticipated that a consultation paper on the essential characteristics of primary and secondary listings will be released by SEHK in 2012.
- **Market misconduct and oversight of disclosure for listed CISs:** We also plan to extend the market misconduct and disclosure of interest provisions in the Securities and Futures Ordinance (SFO) to listed closed-ended collective investment schemes (CISs). Legislative amendments will be proposed to the Government this year.

Raise standards of intermediaries

Intermediary standards are a crucial element of investor protection and we continue to make significant progress in this area:

- **Code of Conduct* revisions:** New requirements concerning the sale of investment products under the revised Code of Conduct for intermediaries took effect in phases and were fully implemented in September 2011. We will continue to monitor compliance through thematic on-site inspections.
- **Code of Conduct* revisions and FDRC:** To pave the way for launching the Financial Dispute Resolution Centre Ltd (FDRC), we implemented changes to the Code of Conduct in June 2012 to require licensed corporations and registered institutions to enhance their complaint handling procedures and comply with the FDRC Scheme. The FDRC will cover services provided by financial institutions regulated by the SFC and HKMA and will handle monetary disputes involving amounts up to $500,000 via mediation and arbitration.

  Other revisions were made to the Code of Conduct to combat market misconduct and improve the regulatory oversight of financial markets. Coming into effect on 1 December 2012, these include:

  – extending the retention period for telephone recordings for client orders from three months to six months,

  – banning the use of mobile phones to accept client orders in the workplace,

  – requiring written authorizations to allow third parties to place orders in client accounts,

  – requiring financial institutions to report to the SFC suspected market misconduct on the part of clients, and

  – requiring financial institutions normally to permit their employees to provide expert witness services to the SFC and the HKMA.

- **Professional investors:** In December 2011, we refined the evidential requirements for ascertaining whether a person is a professional investor (PI) and added other types of corporations to the PI category. We are undertaking a comprehensive review of the whole PI regime and plan to consult the public in 2012.

Continue with effective enforcement

We will continue to tackle actively financial misconduct and crimes. In the coming year, we will look more closely at initial public offering (IPO) sponsor conduct and the management of listed companies. We will also make full use of our powers under sections 213 and 214 of the SFO and apply to the High Court in appropriate cases for remedial relief to protect the interest of investors. We also will strengthen our enforcement co-operation with Mainland and overseas regulators to protect Hong Kong markets from illegal activities of market participants located outside Hong Kong.

Now that we are able to institute proceedings in the Market Misconduct Tribunal directly, we will ensure that our resources are sufficient to handle this additional responsibility. We will operate this new power to ensure that market misconduct is dealt with effectively, efficiently and fairly.

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Help launch an investor education body

Following the recent passage of the enabling legislation, we will establish a dedicated SFC subsidiary – the Investor Education Centre – to be responsible for education covering a broad range of banking, securities and other financial services and products.

The new centre is expected to be operational by October 2012.

Focus 3: Continue to foster Hong Kong's development as an IFC

Helping enhance Hong Kong's standing as a viable and sustainable IFC is one of our mandatory objectives and hence, a core component of our work.

Further develop Hong Kong as a renminbi centre

Hong Kong has a pivotal role in the continued internationalisation of the renminbi, reinforcing its position as the primary hub for capital flows to and from the Mainland.

We will continue to support the Government's initiatives in developing Hong Kong's offshore renminbi business, engaging in developing policies with local and Mainland authorities as well as with the financial industry. Developing robust market infrastructure to support these developments is critical.

We will continue with our investor education campaigns to help the public understand the key features of renminbi investments.

Implement a paperless securities market

We will continue to work on implementing a wholly electronic, paperless securities settlement system to enhance the overall efficiency and competitiveness of Hong Kong's market.

In the coming year, we aim to consult the public on the related subsidiary legislation to implement this initative.

Focus 4: Execute organisational change

To be effective in an increasingly complex environment, the development of our people, clear external communications and internal collaboration and alignment around our core objectives are vital.

Promote internal co-operation

We have launched cross-divisional project groups initially focusing on anti-money laundering, direct access to the Market Misconduct Tribunal, disclosure by listed companies of price-sensitive information under new legislation, the regulation of IPO sponsors and OTC derivatives, and international work. The R&S unit is a new, important aspect of our internal alignment around key risks. In addition, we will continue to enhance our ability to centralise our approach to policy development and research.

Develop our people and further diversify our experience

We will continue to develop our personnel and ensure that they have all the essential tools and up-to-date information to carry out our regulatory functions.

An exercise to brand the SFC as "an employer of choice" will be launched this year to attract high-calibre candidates for different positions from the financial markets. The ultimate objective is to add a rich diversity of experience and skills to our organisation.

Improve external communication

We are finalising the revamp of our corporate site and plan to launch a much more functional and informative version in the third quarter of 2012.

Deploying user-friendly navigation and powerful search functions, the new site aims to better serve the needs of a broad range of stakeholders, ranging from intermediaries to financial firms, other market participants, opinion makers and the general public.